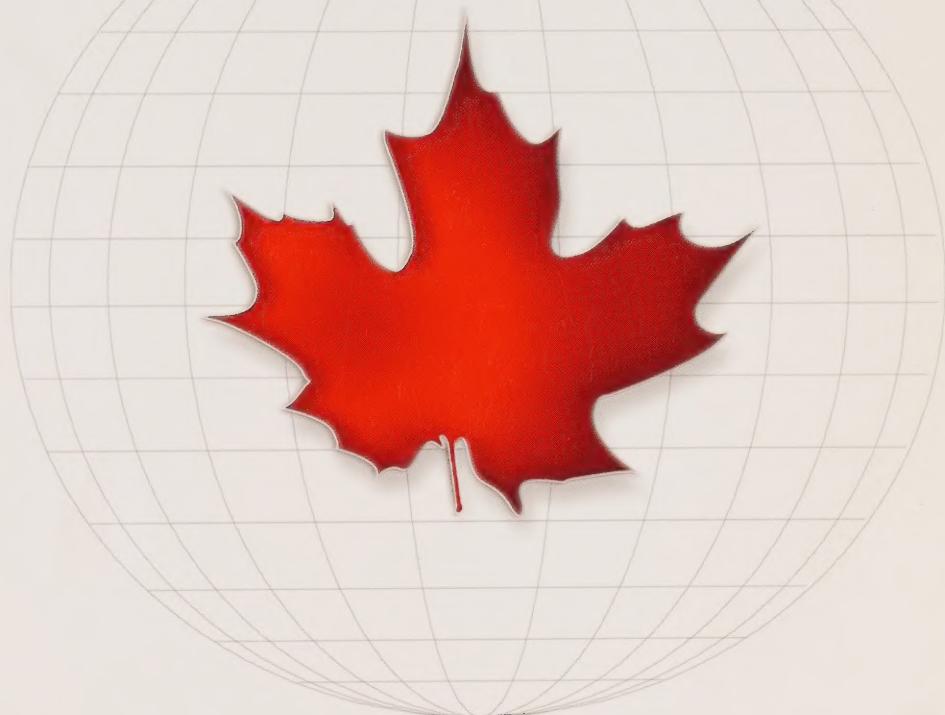


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A Plan for Growth and Prosperity



November 2005



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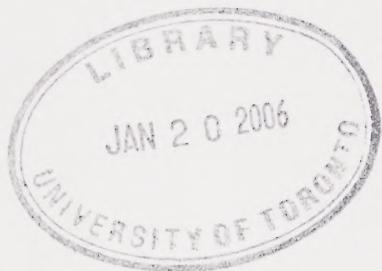
A Plan for Growth and Prosperity

November 2005



Department of Finance
Canada

Ministère des Finances
Canada



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Executive Summary

By virtually every measure, over the past decade the Canadian economy has been one of the most successful in the world. Since 1997 our country has posted the longest string of federal budget surpluses in our history and our records of growth in living standards, job creation and debt reduction are unmatched by any other major country.

With more and better jobs, rising incomes and lower interest rates, Canadians have been able to invest in our families, skills, homes and businesses. Over the same period, the federal government has reinvested in our social foundations including health care, child care and education. These combined investments have improved our standard of living and secured our common future.

This success was no accident. In 1994 the Government set out a bold economic agenda. With the support and sacrifice of Canadians, the Government consistently implemented that plan over the past decade. It has worked, delivering huge social and economic dividends to Canadians.

To build on that progress and to maintain a quality of life second to none, our country must now focus on the opportunities and challenges that will shape the world over the next two decades, in particular:

- the rapid growth of new economic giants such as China and India, as well as the widespread adoption of new ways of producing and delivering goods and services around the world; and
- the challenge posed to our future standard of living as the baby boom generation retires and the relative number of working-age Canadians begins to shrink.

The time has come for a new economic plan to update priorities, set core policy directions and guide future budget decisions.

A NEW PLAN

At its core the new Plan is about Canadians—our quality of life, the kind of communities in which we live, the kind of retirement we can expect to enjoy, and the kind of opportunities our children will have in the coming decades. This Plan will foster our shared goals of a sustainable environment, safe and creative communities, and high-quality public health care.

The new Plan anticipates the profound reordering of the global economy and outlines Canada's response.

It recognizes that future increases in our standard of living will depend in large measure on further improvements in the productivity of our economy.

The Plan recognizes that our economic growth must be sustainable, guided by an ongoing commitment to environmental stewardship.

It acknowledges that the Government of Canada alone cannot achieve the goals of greater jobs, growth and sustainable prosperity, but rather that all orders of government, private firms, labour unions, non-profit agencies and individual Canadians will play important roles in building the Canada we want and our children deserve.

Above all, the new Plan responds to the challenge of building a successful and sustainable 21st century economy by investing in people, promoting innovation and facilitating the freer flow of people, goods, services and capital within our borders and across our borders.

It proposes action on four fronts:

- Creating opportunities for all Canadians.
- Advancing an innovative economy.
- Positioning Canada at the centre of global commerce and networks.
- Building the right investment environment.

CREATING OPPORTUNITIES FOR ALL CANADIANS

In a world of accelerating technological change, there is a greater premium than ever on the skills, knowledge and innovative spirit of Canadians. Every region of our country can benefit from the new globally networked economy and its rapidly growing consumer class. To realize this potential and for fundamental reasons of fairness, the single most important investments we as a country can make are those that ensure all Canadians have the opportunity to acquire the skills, training and education they need to succeed in the 21st century workplace.

The Plan focuses on the following fields of action:

Early learning: Early learning and child care to help ensure children arrive at school ready to learn is the foundation of a world-class workforce. The Government has already taken important steps including a series of early learning and childhood development agreements with provinces. It will do more, and this Plan reaffirms its long-term commitment.

Post-secondary education: Canadians are among the most highly educated people in the world. This not only enriches our lives, but also gives us a competitive advantage in developing and applying new ideas and processes. Despite this success, there remains room for further improvement. For example, we have relatively fewer university graduates with science and business degrees or with combinations of both skill sets. As a nation, we have underinvested in graduate education. Most fundamentally, we must remain vigilant to ensure that barriers to post-secondary education are minimized.

Skilled work: Despite our high rates of post-secondary education, a relatively large number of Canadian workers have low skill levels. We also appear to have a lower rate of workplace training investment by employers than countries like the United States. Business, labour and all levels of government must work together to significantly improve this performance. The Government will continue to work with Canadians to improve their literacy skills, which are necessary to participate in and to benefit from the knowledge economy. Otherwise, Canadian workers could eventually find themselves at a disadvantage in an increasingly competitive global economy.

Inclusiveness: Improving opportunities to participate in the labour force can help compensate for our demographic challenge. Certain groups—older workers, persons with disabilities and recent immigrants—currently experience lower employment rates than our overall population. The Plan sets out initiatives to help close these gaps and to create opportunities for all Canadians.

Aboriginal opportunities: The Government has given particular priority to closing the gap in living standards and life choices between Aboriginal and non-Aboriginal Canadians. The first ever First Ministers' Meeting (FMM) with Aboriginal leaders and devoted to Aboriginal issues provides an important opportunity to transform approaches to health, housing, economic development and, above all, education. It can also launch a new relationship built on mutual respect, recognition of rights, and a commitment to the principle of good governance.

To help create better opportunities for Canadians, the Government of Canada will work to:

Enhance Canada's World-Class Workforce

- ✓ Achieve excellence in post-secondary education by continuing to minimize barriers to access by expanding grant programs and ensuring that student financial assistance programs continue to meet the needs of students.
- ✓ Encourage international education opportunities.
- ✓ Encourage graduate study opportunities, especially in the sciences and management.
- ✓ Promote a culture of lifelong learning and skills upgrading by working with business, labour and provincial partners to enhance workplace-based skills development—including literacy, essential skills and apprenticeships.

Meet the Demographic Challenge

- ✓ Increase workplace participation of under-represented groups such as older Canadians and people with disabilities by removing barriers to participation and improving incentives.
- ✓ Increase immigration of skilled and educated workers.
- ✓ Improve immigrant processing, settlement and integration.
- ✓ Partner with provinces, business and professional associations to better match immigrants with skill requirements, broaden the regional distribution of immigrants and improve foreign credential recognition.

Create Aboriginal Opportunities

- ✓ Agree on effective partnerships and transformative approaches to health, housing, economic development and education at the upcoming FMM.

Improve Labour Mobility and Labour Market Efficiency

- ✓ Reduce barriers to labour mobility across the country, working with provinces, territories and stakeholders.
- ✓ Improve the quality and timeliness of labour market information.
- ✓ Ensure that the Employment Insurance Program, on an ongoing basis, effectively meets the changing needs of the workforce and the economy.

ADVANCING AN INNOVATIVE ECONOMY

A successful 21st century economy creates and quickly adopts leading-edge technology. An innovative economy rests on the foundation of knowledge created in its universities, the level of excellence it attains in new discoveries and its success in training people with advanced skills. Our country must constantly improve its capacity to generate the knowledge, innovation and research that lead to new products, services and methods of doing business in order to provide working Canadians with better jobs and incomes. Sustained, long-term economic growth also requires a comprehensive and innovative approach to environmental sustainability.

The Plan focuses on the following fields of action:

University-based research: Primary and applied research by universities—including participating in international research projects—are a key source of the new ideas and innovation our country needs. Research-intensive universities also train highly skilled graduates that businesses increasingly need to develop and adopt new technologies.

Canadians can be justifiably proud of the progress we have made in this area over the past decade. Canada now leads the Group of Seven (G7) industrial nations in university-based research and development (R&D), an advantage our country must maintain through further investment.

Private sector R&D and technology adoption: There are signs that the improved policy environment since 1994 has encouraged some sectors of the economy to increase their R&D investments. However, while some of Canada's industries have a strong R&D record, overall, our private sector R&D investment is still relatively low by international standards, especially vis-à-vis the U.S.

Commercializing new technologies: The ability to transform innovative ideas into new products and processes is an important source of economic growth. Canada can further capitalize on our leadership in university R&D. Although Canadian universities create about the same number of licences per research dollar as U.S. schools, they tend to receive less income for this intellectual property. In addition, Canadian companies report that new products and services make up a lower share of their sales than firms abroad.

To help build a more innovative economy, the Government of Canada will work to:

Retain Leadership in University-Based Research

- ✓ Maintain Canada's G7 leadership in university-based research through increased investment.
- ✓ Make major ongoing investments to build world-leading equipment and facilities, attract the best researchers and support primary research.
- ✓ Improve its monitoring of investments and strengthen reporting of research success.

Strengthen International Research Networks

- ✓ Strengthen its support for universities and researchers to develop international networks and participate in research partnerships that improve Canada's access to leading-edge research.
- ✓ Make it easier for the best and the brightest researchers from around the world to work in Canada.
- ✓ Fulfill our commitment to devote 5 per cent of federal R&D to problems faced by the developing world, including in areas such as health and environmental technologies.

Encourage Private Sector R&D and Technology Adoption

- ✓ Build the right environment for private sector investment in R&D and technology.
- ✓ Introduce new programs to enhance existing support for technology development and adoption.

Accelerate the Commercialization of New Technologies

- ✓ Increase the commercialization capacity of established clusters of economic activity.
- ✓ Improve collaboration between university and private sector researchers.
- ✓ Strengthen the management and commercial capabilities of scientists and engineers.
- ✓ Implement new models for managing government laboratories to strengthen clusters of university and private sector research excellence.

POSITIONING CANADA AT THE CENTRE OF GLOBAL COMMERCE AND NETWORKS

Canada is a trading nation, with exports representing 40 per cent of our economy. That's more than any other G7 nation. But the global environment is continuing to change, with giants such as India and China becoming not only more important markets for our resources and goods, but also competitors in global supply chains. Canada must pursue an aggressive trade and investment strategy to help our companies—especially small and medium-sized firms—take greater advantage than ever of opportunities in global markets and position themselves in the high-end, value-added component of global supply chains.

The Plan focuses on the following fields of action:

Supporting open markets: Countries that are open to trade and investment are usually more innovative, productive and competitive than those that are not and they generally enjoy better economic growth, job creation and incomes. That is why Canada has been a long-time proponent of rules-based international trade in forums such as the World Trade Organization and through agreements such as the North American Free Trade Agreement. Among the nations of the world Canada has always been, and will continue to be, an ardent advocate for both free and fair trade.

Foreign direct investment: Canada is well on its way to becoming a net foreign investor for the first time in our history, making the protection of Canadian investors' interests in foreign markets more important than ever. At the same time, foreign investment in Canada will remain an important source of new technology, ideas and jobs.

Global business networks: Emerging economic giants offer dramatic market opportunities for Canadian firms from natural resources to environmental and other advanced technologies. To seize this potential, our firms, particularly small and medium-sized ones, will need export start-up help from government, including information on local business conditions, licensing, subcontracting and regulation.

World-class gateways: Countries are linked to their trading partners by "gateways" where land, marine and air transportation networks converge and, supported by advanced communications, connect centres of economic activity. The Windsor-Detroit corridor and key Pacific Coast transport facilities, among others, are essential to our future ability to expand trade with major markets. Another form of gateway—broadband communications networks—will be important in connecting all Canadians to new information and business opportunities anywhere in the world.

To help position our country at the centre of global commerce and networks, the Government of Canada will work to:

Open Canada to the World

- ✓ Review Canada's tariff regime to improve competitiveness and attract investment—for example by reducing tariffs on manufacturing inputs—and pursue trade negotiations that open key international markets for Canadian business.
- ✓ Move forward on the Security and Prosperity Partnership of North America to make our societies safer and more secure, our businesses more competitive and our economies more resilient.
- ✓ Ramp up our Foreign Investment Promotion and Protection Agreement program to help our firms connect to global supply networks, especially with respect to priority markets such as India and China.
- ✓ Improve our trade and investment climate by concluding negotiations with the U.S. on tax treaty changes, reviewing Canada's restrictions on foreign investment in the air transportation sector, and acting on the findings of the telecommunications review.

Position Canada in Global Business Networks

- ✓ Develop a government-wide network of services and programs to identify opportunities in key emerging markets, showcase Canadian strengths and achieve results through successful commercial strategies.
- ✓ Increase trade promotion services, especially for small and medium-sized businesses.
- ✓ Further the integration of emerging economies into the global economy through bilateral initiatives and our leadership position in the G7 and G20.
- ✓ Work with Canadian businesses in emerging markets to promote issues of corporate social responsibility.
- ✓ Facilitate global market opportunities for Canadian companies to develop and deploy environmental technologies through the United Nations Framework Convention on Climate Change and other international processes.

Create World-Class Gateways

- ✓ Promote trade opportunities with emerging Asia-Pacific economies and the United States by supporting the further development of Canada's Pacific gateway and the Windsor-Detroit corridor through infrastructure investment and supporting policy initiatives.
- ✓ Explore further liberalization of Canada's air transport agreement with the United States and other countries.
- ✓ Improve access to global telecommunication networks by investing to better connect remote, rural and Aboriginal communities to broadband networks where private service is lacking.

BUILDING THE RIGHT INVESTMENT ENVIRONMENT

We live in a world where people and businesses are increasingly able to move to where they can obtain the greatest advantage. In this environment, the best way for government to support jobs, growth and prosperity is to create the right conditions for private investment and initiative.

The Plan focuses on the following fields of action:

Maintaining our fiscal advantage: Canada's dramatic fiscal turnaround—from 27 years of yearly federal deficits to 8 consecutive years of surplus—is no abstract achievement. It has helped hold our interest rates down to near historical lows, which, in turn, has led to increased private investment, greater economic activity and record job creation. With new challenges on the horizon, including increased spending pressures associated with an aging population, it is critical that the Government maintain its strong focus on fiscal discipline and debt reduction so that Canada has the flexibility to meet future needs.

Improving the competitiveness of our tax system: The tax system can have a direct and determining impact on incentives to work, save and invest. Canada needs to attract and retain the most highly skilled workers and to encourage all Canadians to take advantage of opportunities in the workplace to better their lives and those of their families. We must also encourage savings so that Canadians can aspire to home ownership, a comfortable retirement and higher education. Finally, in a global economy where capital is highly mobile, the tax system needs to be competitive to encourage the investments that create new economic activity, well-paying jobs and more productive and efficient business.

Promoting efficient regulations and financial markets: Regulations are essential to protect the health and safety of Canadians, support a clean environment and underpin a well-functioning market system that promotes saving and investment. They must also be constantly reviewed to ensure they are still serving the best interests of Canadians.

Strengthening Canada's economic union: The free movement of people, goods, services and capital across our country is vital to its economic strength and competitiveness. While progress has been made, there remain too many artificial barriers within our own borders to the mobility of our citizens and the movement of goods and services. More work with the provinces and territories is required on a range of issues including the recognition of professional and trade qualifications and the more efficient regulation of securities.

Driving greater productivity in government: Getting government right is an important part of building the right environment for investment. The Government must constantly strive to make its programs and services as efficient and cost-effective as possible. It must also maintain the highest possible ethical standards and ensure that its operations are carried out in ways that enable Canadians to clearly see and assess what our government is doing and why.

Promoting energy efficiency and environmental sustainability: A sustainable economy depends on a sound environment. The Government of Canada has made substantial investments in support of a healthy environment and a competitive economy. Further measures consistent with the framework outlined in Budget 2005 will be implemented to promote energy efficiency, spur technological innovation and facilitate adaptation. Such measures will increase the efficiency, sustainability and international competitiveness of the Canadian economy.

**To help create the right environment for investment,
the Government of Canada will work to:**

Maintain Canada's Macroeconomic Advantage

- ✓ Maintain the Government's commitment to balanced budgets or better and its balanced approach to the allocation of surpluses—including unanticipated surpluses in excess of the Contingency Reserve—between debt reduction, tax relief and investments in key economic and social priorities.
- ✓ Keep the federal debt-to-GDP (gross domestic product) ratio on a downward track to create future fiscal flexibility to help deal with the pressures of an aging population, including setting a new objective of reducing that ratio to 20 per cent by 2020.
- ✓ Maintain low, stable and predictable inflation by extending the Government's inflation target agreement with the Bank of Canada for a further five years in 2006.

Improve the Competitiveness of Our Tax System

- ✓ Reduce personal income taxes at all income levels to make it more attractive for Canadians to join the workforce, to stay working and to save. In particular, the Government will focus on reducing marginal tax rates to improve incentives.
- ✓ Consult with provinces and territories to design and introduce an effective Working Income Tax Benefit to make work pay for low-income Canadians and help them achieve self-sufficiency.
- ✓ Ensure Canada has an internationally competitive corporate tax system. In particular, the Government's goal will be to reduce the impact of the tax system on investment; to establish a meaningful overall, or marginal effective tax rate advantage vis-à-vis the United States; and to make the tax system as neutral as possible with respect to business structure, financing and investment.
- ✓ Encourage Canadian investment abroad and foreign investment in Canada by, among other things, enhancing tax treaties with other countries and ensuring that those capital flows serve lawful and productive purposes.

Promote Regulatory and Financial Market Efficiency

- ✓ Reform the Government's regulatory system based on the principles of Smart Regulation.
- ✓ Reduce the paper burden on Canadian business by working with the private sector and other orders of government to minimize complexity and duplication.
- ✓ Ensure that the regulatory framework governing the financial sector, capital markets and pensions promotes soundness, efficiency and competitiveness, and serves the needs of individuals, businesses and the economy.
- ✓ Continue discussions with the provinces and territories on a single securities regulator and other approaches to achieve a new, enhanced system of securities regulation.

**To help create the right environment for investment,
the Government of Canada will work to: (cont'd)**

Strengthen Canada's Economic Union

- ✓ Encourage provincial governments to implement tax reforms that enhance productivity, including eliminating provincial capital taxes and reforming retail sales taxes.
- ✓ Strengthen Canada's economic union through further development of the Agreement on Internal Trade with the provinces.
- ✓ With the provinces, enhance workplace-based skills development, including literacy, essential skills and apprenticeships.

Improve Productivity in Government

- ✓ Update the Government's expenditure management system to better link spending to achievements and improve the quality of information for Parliament.
- ✓ Further professionalize the public service by investing in learning.
- ✓ Strengthen internal audit and evaluation capacity across the public sector.
- ✓ Perform ongoing reviews of major portfolios to create a culture of expenditure review.

Promote Energy Efficiency and Environmental Sustainability

- ✓ Encourage the development and adoption of energy-efficient and environmentally sustainable technologies, situating Canada's industries at the forefront of a growing global market.
- ✓ Use market mechanisms to tap greenhouse gas reduction potential across the Canadian economy, spurring innovation at a national level.
- ✓ Encourage energy-efficiency improvements and other competitive structural changes for Canadian consumers, industry and governments.
- ✓ Use the Government of Canada's purchasing power to improve its environmental performance.
- ✓ Provide leadership in international fora to promote technology adoption, market development and international cooperation.
- ✓ Pursue other opportunities to use the tax system and other incentives to support environmental objectives.

THE WAY FORWARD

This Plan sets out a medium-term economic framework for action. There is no single initiative that can guarantee sustainable prosperity; it cannot be delivered in a single year or a single budget. Instead, just as with slaying the deficit, success will require a sustained effort, with an unremitting focus on results. As with the deficit, Canadians can be confident of success.

The federal government cannot do it alone. Success will require partnerships with the provinces, labour and business. The federal government is committed to working with the provinces across a wide range of initiatives that will affect Canadian prosperity.

Ultimately, Canadians will determine our success. And there are great reasons to be confident. Collectively, we have turned this country around since 1993 from laggard to leader among the major economies. We have unique strengths including our diverse and highly skilled population, openness to the world, immense natural resource potential and robust financial health. Most importantly, we retain the same adventurous spirit that built this great country and that can make this global opportunity our destiny.

The reward is clear: a quality of life second to none.

Introduction

This Plan presents a broad economic policy framework that will guide the Government of Canada over the coming years in fostering employment, economic growth and prosperity. The Plan builds the foundation to realize a vision of Canada where "...our quality of life will be second to none."¹

We start from a position of strength. The hard work of Canadians over the past decade has built on an enviable record of fiscal stability, economic performance and social cohesion. Uniquely positioned to benefit from global trends, Canada is a prosperous nation, confident of its place in the world.

As individuals, each Canadian has an important role to play in achieving this vision. Together, Canadians can make it happen.

STANDARD OF LIVING IS A KEY DETERMINANT OF QUALITY OF LIFE

Public policy's core strategic objective is to create opportunities for every Canadian to achieve personal fulfillment through work and leisure in a free and just society. In this context, the ultimate goal of economic policy is to improve our quality of life by increasing living standards. Quality of life is a broad concept of social well-being that depends on a range of factors: living standards and health, the environment, culture, families, national security and global citizenship. While this Plan focuses on improving living standards, it is part of a broader framework.

The Government's Plan Aims to Increase Quality of Life



¹ Address by Prime Minister Paul Martin, Gatineau, Quebec (September 20, 2005).

Living standards and other determinants of quality of life are interrelated. For example, higher living standards generate the resources that society needs to address the other factors that determine our well-being. Ultimately, quality of life is especially important to ensure that the best and the brightest are attracted to and remain in Canada. Overall quality of life contributes to our economic prospects. For example, high-quality health care provides a competitive advantage to Canadian business due to a healthy workforce and low, stable employer costs. Our approach will continue to put the patient at the centre of reform. The Government will work with the provinces to sustain a Canadian health care advantage by increasing the timeliness and predictability of the high-quality service.

Budgets 2004 and 2005: Recent Progress in Promoting Quality of Life

Health: Building on the health accords of 2000 and 2003, all First Ministers signed the 10-Year Plan to Strengthen Health Care in 2004, a plan that includes a commitment to improve access to publicly funded health care and reduce wait times for key services. In support of this plan, the federal government announced over \$41 billion in new long-term funding for Canada's health care system.

Environment: In 2005 the federal government laid the foundation for Project Green, a comprehensive set of policies and programs aimed at supporting a sustainable environment and a more competitive economy. Budget 2005 provided important impetus for Project Green, including \$4 billion towards the Government's Climate Change Plan.

Communities and Culture: The Government of Canada is committed to sustainable, creative, safe and secure communities. Budget 2004 announced the first major step to deliver the New Deal for Cities and Communities, providing \$7 billion over 10 years by increasing the goods and services tax rebate to municipalities. Budget 2005 provided an additional \$5 billion over five years for cities and communities based on a share of federal gas tax revenues. In addition to nearly \$740 million since 2001, new funding totalling \$860 million was announced in Budget 2005 for the Tomorrow Starts Today initiative, which supports Canadian arts and culture.

Families: Building on the \$965-million-per-year increase in the National Child Benefit supplement announced in Budget 2003, Budget 2005 allocated \$5 billion over five years for the Early Learning and Child Care initiative. Budget 2005 also announced a \$2.7-billion increase in the Guaranteed Income Supplement over five years for low-income seniors.

Canada and the World: The 2005 International Policy Statement details Canada's new priorities in the area of defence, diplomacy, development and trade. The policy builds on commitments announced in Budget 2005, including \$3.4 billion for international assistance, and over \$12 billion for defence, the largest increase in defence funding in 25 years. The Government has also allocated more than \$9.3 billion for new security measures since 2001, including funding for Canada's National Security Policy and for air and marine security, intelligence and policing, emergency preparedness, and border security. Since 2005 the Government has also invested \$58 million towards pandemic influenza preparedness, including the purchase of antiviral drugs.

CANADIANS LIVE AND WORK IN A CHANGING ENVIRONMENT

As we refresh and strengthen our economic policy framework, we do so with the benefit of a robust economy and a sound fiscal position. As detailed in Chapter 2, through decisive actions and sacrifices made since 1994, Canadians have made tremendous progress. Since the federal deficit was eliminated in 1997, resources have been freed up and invested in key economic and social priorities.

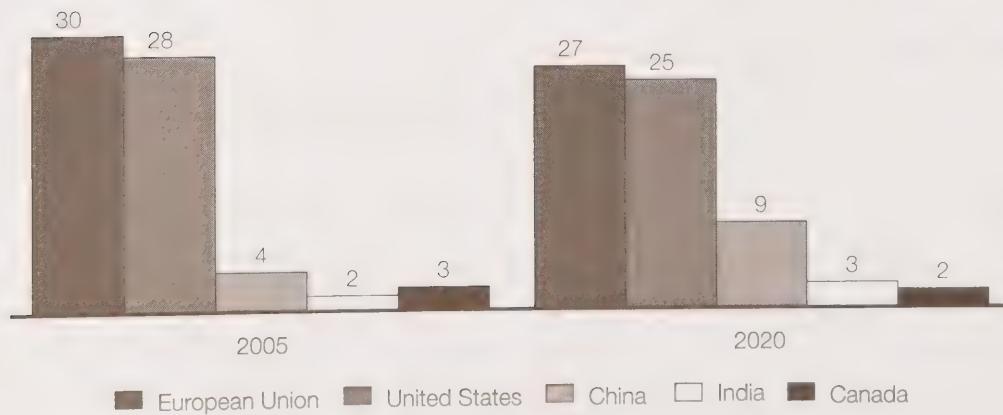
Most importantly, Canadians have returned to work. Among the world-leading G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), Canada is first in job creation since 1997, with overall participation in the labour market now at an all-time high and unemployment at a 30-year low. Over the same period, Canada experienced the second largest increase in average productivity growth compared to other G7 economies. Canada also led the G7 in the growth of living standards.

Reinvestments in our families, homes, workplaces, institutions and public services were begun and are accelerating.

Today, the balance of economic power is shifting due to the simultaneous emergence of economic giants such as China and India, and the widespread adoption of transformative information and communications technologies. China is expected to become the world's second largest economy by 2020, while India's share of the world economy is on track to surpass that of Canada later in the next decade. But Canada is well placed to thrive in this new economic environment.

Shifting Economic Balance

Share of World Economy
(Per Cent GDP)



Source: Global Insight, *World Overview*.

At the same time, like many other advanced economies, Canada faces an aging population. In future years, younger generations will comprise a smaller share of our population. As a result, automatically rising employment will soon no longer contribute to living standards growth. This demographic change will also test the strength of our public finances due to increased pressures on Canada's health system and social programs.

Canada's continued success will demand steadfastness in our response. As Canadians have shown over the past decade, with a focused plan we can meet challenges and seize new opportunities. This economic policy statement lays the groundwork for a confident, successful response.

Canada's Baby Boom Generation

"Looking ahead, as Canada's baby boomers pass into retirement, the dependency ratio will rise and the working age population shrink in the absence of net inflows of migrants. Responding to these developments presents the country with two key challenges:

- Maintaining steady improvements in living standards, despite increases in the old age dependency ratio. This will mainly require continued strong rates of productivity growth, although adjustments to policies affecting labour supply could contribute by attenuating the expected fall in total hours worked.
- Ensuring that public finances across all levels of government remain sustainable in the long term, especially given the upward pressures on publicly financed health care outlays."

Organisation for Economic Co-operation and Development,
Economic Survey of Canada 2004

DEVELOPING A GLOBAL PERSPECTIVE

To succeed in the 21st century, Canadians must nurture a global perspective. This Plan takes a global perspective in several ways:

- It recognizes the acceleration of the globalization process resulting in part from the widespread application of information and communications technologies.
- It anticipates the profound reordering of the global economy wrought by the emergence of new economic giants such as China and India.
- It responds to the challenge of developing a cutting-edge knowledge economy under these circumstances by investing in people, creating the right investment environment, promoting innovation and facilitating the freer flow of people, goods, services and capital.
- It takes advantage of increased demand for natural resources to drive efficient development of our immense potential.
- It advances our responsibility to promote global environmental sustainability and responds to the increasing need for our industries to be as environmentally efficient as possible in order to compete internationally.

In its entirety, the Plan seeks to position Canada as a leader in the global economy.

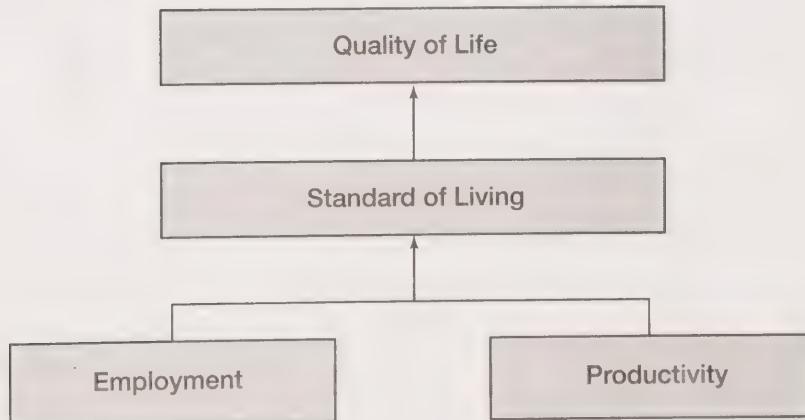
ADVANCING FROM A POSITION OF STRENGTH

As we re-examine the objectives and directions of economic policy, there are reasons for renewed optimism. Initiatives since 1994 have given us the freedom to plan and act for the long term. This means that today we can prepare for the Canada we want over the next 15 years, rather than worrying about how to make ends meet tomorrow. This enviable position is the payoff from putting the deficit years behind us.

Canada is uniquely positioned to benefit from the profound reordering of the global economy due to our diverse and highly skilled population, openness to the world, immense resource potential and robust financial health. However, our success is not a birthright. To fully realize our potential and to provide every Canadian with the opportunities they deserve, we must take our economic performance to the next level.

At its core, this means creating opportunities for all Canadians. Specifically, we must ensure that everyone has the opportunity to acquire the necessary skills and no one faces insurmountable barriers to achieving personal fulfillment through work. This fundamental commitment to fairness must be complemented by an improvement in our productivity performance. Productivity is only a means, not an end in itself. A more productive economy is the only dependable route to better jobs, larger disposable incomes, improved living standards, and ultimately a higher quality of life for Canadians.

Productivity Is Key to a Higher Standard of Living and Quality of Life



PROGRESS IN LIVING STANDARDS DEPENDS ON PRODUCTIVITY

To boost living standards we must focus on improving productivity. Standard of living, commonly measured as GDP per capita, depends on the number of people working, the amount of time they work and the efficiency with which they work. At the margin, a change in any of the components translates into an equivalent change in living standards. Given that we are currently at a record-high rate of employment and Canada's population will increasingly age in coming years, growth in employment will have a diminishing impact. Any significant future increase in the Canadian standard of living will come either from an increase in the average number of hours worked or in the output of our work effort.

We have a choice between working harder or working smarter.

PRODUCTIVITY MEANS WORKING SMARTER

Working smarter simply means producing more with the same or even less effort. In a practical sense, evidence shows that improvements in living standards depend in large measure on investments in key areas that drive productivity and economic growth—people, physical capital and innovation. Indeed, economies that exhibit strong performance in all three areas are the most successful in generating new and better jobs and improved living standards. Equally important are government policies that support the development and interaction of these factors, including policies that set the right macroeconomic environment, encourage competition and promote efficient markets.

For Canadians, working smarter has been the foundation of our economic progress. In fact, productivity has proven to be by far the most important contributor, accounting for nearly 90 per cent of Canada's improvement in living standards over the past 50 years. The income that Canadian workers earn and the resources available to public and private institutions will increasingly depend on continued advances in productivity.

GOVERNMENT CAN LEAD, BUT SUCCESS REQUIRES PARTNERSHIPS AND A PLAN

More than a decade of solid economic progress in Canada has shown that a government with a clear and resolutely implemented economic plan can help Canadians attain their personal and shared goals. However, the Government of Canada alone cannot guarantee economic success. Other orders of government also play an important role, and ultimately the decisions and efforts of all Canadians—collectively through governments, private firms, labour unions, non-profit organizations and as individuals—will determine our economic performance. All have contributed to our success since 1994. Additional progress will demand a cooperative effort, one where each and every Canadian contributes towards our national goals of economic prosperity and global achievement.

Government does have a unique responsibility to lead, a responsibility this government fully accepts. To be effective, the Government must focus its attention on those areas where it can have the greatest impact. This Plan identifies these priorities.

A PLAN FOR GROWTH AND PROSPERITY

Canadians can realistically aspire to have an economy that will support a quality of life second to none. This Plan sets out how we can attain this goal.

The balance of this paper analyzes in greater depth how productivity grows, and derives from this analysis the economic policy principles that will support the federal government's role in making Canada a leader in quality of life. Chapters 2 and 3 provide the context by reviewing Canada's achievements over the past decade and examining the new challenges and opportunities that we will face in coming years. The forward-looking elements of the Plan are outlined in the following chapters:

- **Creating Opportunities for All Canadians.** In response to key challenges, such as population aging and a changing economic environment, Chapter 4 examines measures needed to fully empower Canadians with the skills and adaptability we need to be completely successful.
- **Advancing an Innovative Economy.** Chapter 5 sets out a multi-pronged approach for enhancing Canada's innovation performance. Innovation is an important driver of economic growth: it makes us more productive, generates new products, opens new markets and enhances competitiveness.
- **At the Centre of Global Commerce and Networks.** Countries that adopt a global approach to business benefit from stronger economic growth and better living standards. Chapter 6 examines Canada's policies from a global perspective, focusing on access to international markets and supporting commercial networks.
- **Building the Right Investment Environment.** Chapter 7 examines the Government's most important role in promoting economic prosperity: to create the right conditions for private investment. This means prudent fiscal management and sound monetary policies, fair, competitive and efficient taxation, smart regulation, efficient financial markets, a deeper Canadian economic union, and more productive government.

As subsequent chapters make clear, there is no simple solution to achieve sustainable prosperity. Rather, improving living standards and ultimately quality of life requires continued and unremitting progress on each interrelated element of the framework. Measures consistent with the policy directions put forward in this Plan are proposed in the accompanying 2005 Economic and Fiscal Update for inclusion in Budget 2006. Additional measures will be launched in subsequent budgets.

A Medium-Term Framework for Raising Living Standards



Canadian Competitiveness: A Decade of Achievement

The Government's economic strategy since 1994 has been a success. The Canadian economy in 2005 is much stronger than it was in 1994, with Canada having the fastest growth in living standards in the G7 over the last eight years. This has created a solid platform upon which a confident Canada can build.

During the 1980s and early 1990s, growth in Canadian living standards decelerated markedly as a result of slowing productivity and employment growth. In 1994, confronted with the country's serious economic problems, the Government of Canada set out a bold economic plan to guide its long-term decision making. The first job was to balance the budget. This was the crucial first step of a broader agenda that established conditions under which the private sector could grow and create jobs. Over the past decade, the Government has also introduced a range of reforms to increase the flexibility and adaptability of our economy. Canadians have responded with energy and determination.

As a result, since the deficit was eliminated in 1997, Canada's job creation and growth records are unmatched in the G7. Eliminating the deficit and reducing our debt burden have allowed the Government to make major reinvestments in Canada's economic, social and international priorities. This success has occurred despite major structural changes and shocks to the economy. Our experience shows that when Canadians prepare for the future with confidence and a plan, we can build a dynamic economy that serves the greater needs of society.

1. 1994 AGENDA: JOBS AND GROWTH

The Government of Canada's response to the country's seemingly intractable economic problems was laid out in *Agenda: Jobs and Growth—A New Framework for Economic Policy*. The document provided a long-term plan with a clear and concentrated focus to bring discipline to the policy-making process and to ensure that the actions of the federal government were consistent and self-reinforcing.

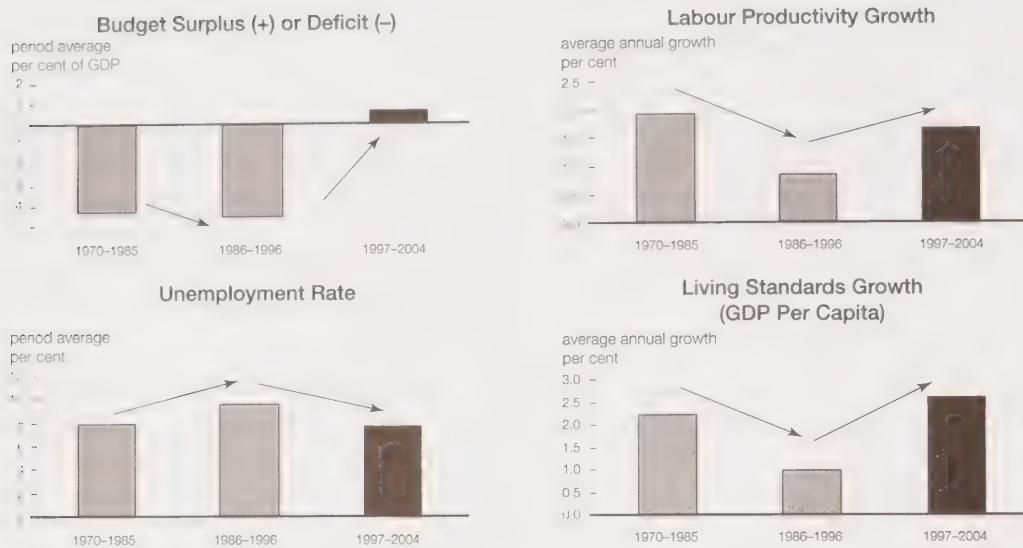
1994 Agenda: Jobs and Growth Policy Objectives

"...the basic objective of public policy is to create the opportunity for every Canadian to achieve personal fulfillment through work and leisure in a free and just society.

"These aspirations can be attained only through a dynamic economy that generates both ample employment opportunities and the financial resources to undertake those public endeavours—including health care, education, cultural development and assistance for the needy, among others—that have made Canada one of the world's most civil societies.

"There is no conflict between economic policy and the broader social objectives of Canadians."

Canada's Economic and Fiscal Turnaround



Sources: Surplus/Deficit—*Fiscal Reference Tables*, Department of Finance Canada (September 2005); Labour Productivity—Statistics Canada; Unemployment Rate—Statistics Canada, Labour Force Survey and Historical Statistics of Canada (1970–1975); Living Standards—Statistics Canada.

The priority was to foster a more productive and adaptable economy, since that was the only way to ensure that Canadians would have more jobs and a rising standard of living. Consistent with this priority was the principle that Canadians needed to be prepared to capitalize on new opportunities. The Government of Canada signalled its intention to act in partnership with provinces, business, labour, communities and individual Canadians. There would be an active and smart government, but not a “big government.” Understanding its limitations, the Government committed to focus its energies where they were most needed, and to live within its means. In the words of the agenda, “the framework will guide what we *will* do in the future and what we *won’t* do.”

Applying these principles to the economic challenges of the day, the new framework for economic policy highlighted five policy areas for action, chosen for their ability to create a coherent and mutually reinforcing strategy for improved economic performance. The Government stated that its economic policy actions would further the following policy directions:

- Helping Canadians acquire skills to foster better job opportunities and incomes for individuals.
- Encouraging Canadians to adapt to new opportunities by ensuring that government policies encouraged both individuals and firms to change when the economic environment changed around them.
- Getting government right so that government itself would be a contributor to a more productive economy.

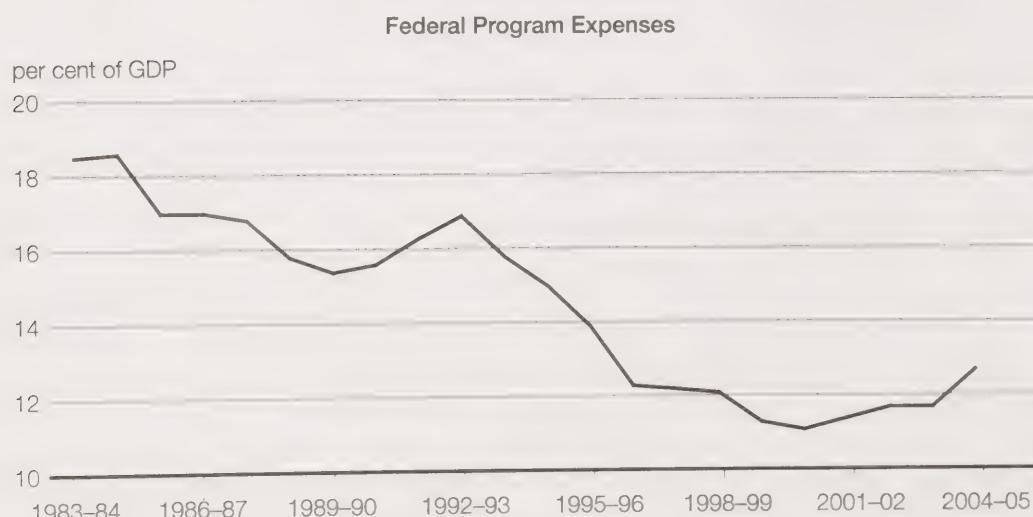
- Providing leadership in the economy in those areas where government was best placed to take the initiative, but always in partnership with the private sector.
- Creating a healthy fiscal and monetary climate by reducing and then eliminating the deficit, with a view to eventually reducing taxes to put in place broad economic conditions for sustained growth and job creation.

Over the past 11 years, this agenda has been implemented and it has worked.

Starting With Macroeconomic Reform

The lynchpin of the economic plan was to strengthen radically Canada's macroeconomic framework by eliminating government deficits and achieving low, stable and predictable inflation. A key factor behind the spiralling government deficits of the 1980s and early 1990s was persistently unaffordable growth in program spending. By 1991, Canada had the second highest total government debt-to-GDP ratio among G7 countries. With such a high debt burden, international lenders worried that Canada might not be able to meet its payments. Interest rates increased to compensate for this perceived risk, which in turn stifled economic growth.

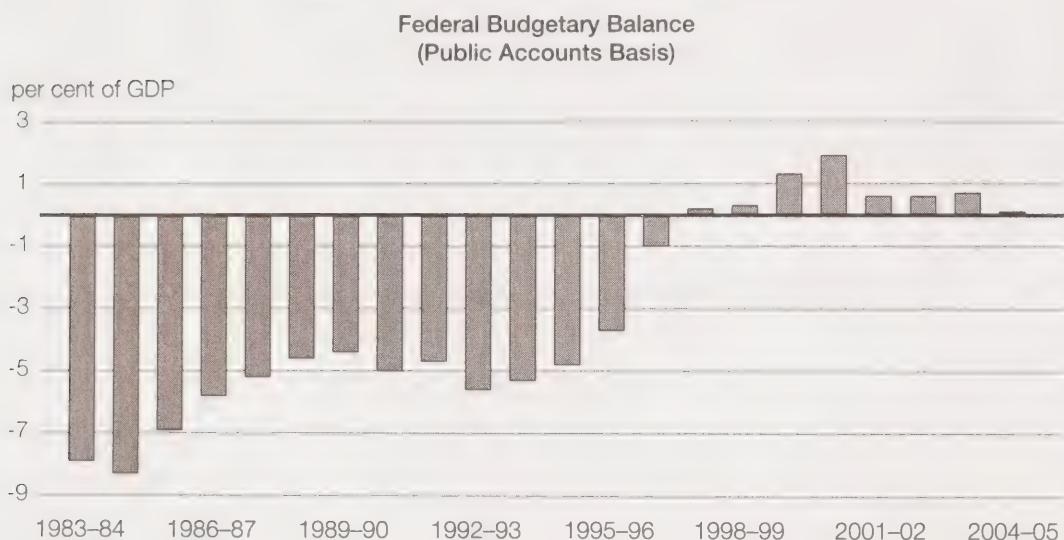
A Significant Decline in Federal Program Spending as a Share of the Economy



Sources: Department of Finance Canada; Statistics Canada.

The elimination of the deficit, achieved mainly by reductions in federal program spending, was an essential component of restoring macroeconomic stability and encouraging faster economic growth. Expenditure reduction initiatives were put in place through the 1995 and 1996 budgets, and federal program spending as a share of the economy declined from almost 17 per cent in 1992–93 to about 12 per cent in 1997–98, the same year that the federal government achieved a fiscal surplus for the first time since 1969–70. This past fiscal year, the federal government posted its eighth consecutive budget surplus, a record unmatched since Confederation.

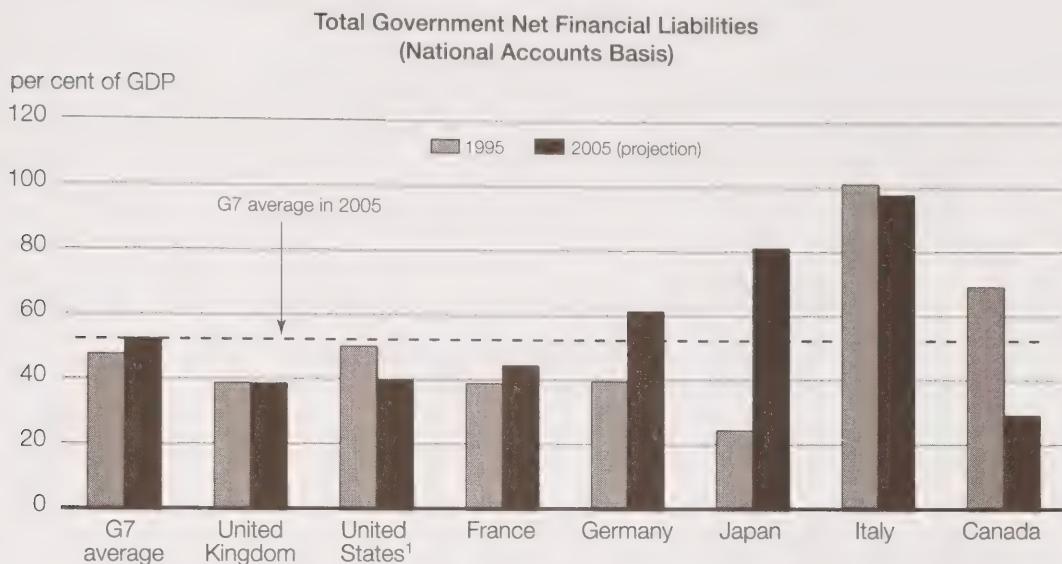
Eight Consecutive Budgetary Surpluses



Sources: *Public Accounts of Canada*; Statistics Canada.

With deficits eliminated, the Government has made considerable progress in reducing its debt, while continued healthy growth of the economy has further lightened the debt burden. In fact, Canada's total government debt-to-GDP ratio is now the lowest among G7 countries. As a result, debt interest payments have declined from almost 40 per cent of federal revenues in 1995–96 to about 17 per cent last year. Improved fiscal conditions and stronger economic growth allowed the Government to implement the largest tax cuts in Canadian history in 2000, while beginning to reinvest in the programs that matter most to Canadians.

Lowest Debt-to-GDP Ratio Among G7 Countries



¹ Adjusted to exclude certain government employee pension liabilities to improve comparability with other countries' debt measures.

Sources: *OECD Economic Outlook*, No. 77 (June 2005); Federal Reserve, *Flow of Funds Accounts of the United States* (June 2005); Department of Finance Canada calculations.

One of the direct payoffs of eliminating the deficit and reducing the debt has been lower interest rates. As Canada proved it was serious about getting its fiscal house in order and about maintaining low and stable inflation through inflation targets, our international fiscal credibility improved, leading to the restoration of the Government of Canada's AAA credit rating (the highest in financial markets). International investors no longer demand a risk premium to hold Government of Canada bonds, thereby helping to lower interest rates. Since these rates act as a benchmark for other interest rates in the economy, buying a home or investing in a business has become more affordable for Canadians. Similarly, provinces and municipalities have seen their cost of borrowing decline.

Lower Interest Rates Have Made Buying a House Easier for Canadians

1-Year Mortgage Rate



Source: Statistics Canada.

Major Structural Reforms

To complement the stronger macroeconomic framework, important steps were also taken to make the economy more adaptable. The Government reformed the employment insurance system and social assistance programs. Trade barriers were further reduced, particularly in 1994, when the Canada-U.S. Free Trade Agreement was expanded to include the phased elimination of tariffs between Canada, the United States and Mexico, although some important trade irritants remain. More recently all products from the least developed countries became eligible for duty- and quota-free entry into Canada.

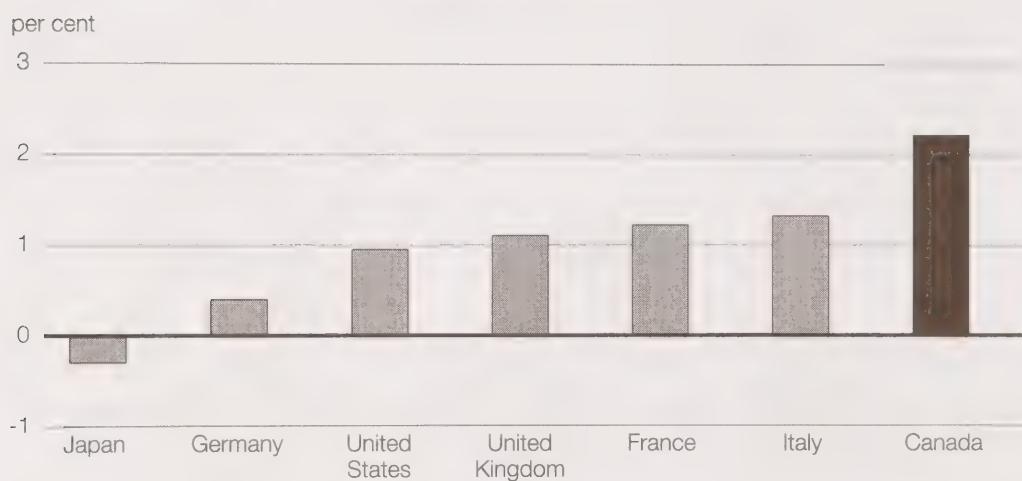
Government regulations were also reformed to promote efficiency and competitiveness. More sectors of the economy, such as telecommunications, were opened to competition. High administrative burdens for new businesses, which had been shown to hamper employment growth, were lowered to make it easier for Canadians to create new companies.

Reforms Contributed to the Sharp Rebound in Jobs and Living Standards

The improved macroeconomic framework, complemented by structural reform, created the right conditions for economic growth, job creation and sustained improvements in living standards. Between 1997 and 2004, the Canadian economy created 2.6 million jobs, putting Canada first among G7 countries in terms of employment growth during this period.

Best Employment Record Among G7 Countries

Employment Growth in G7 Countries, 1997–2004
(Average Annual Growth)

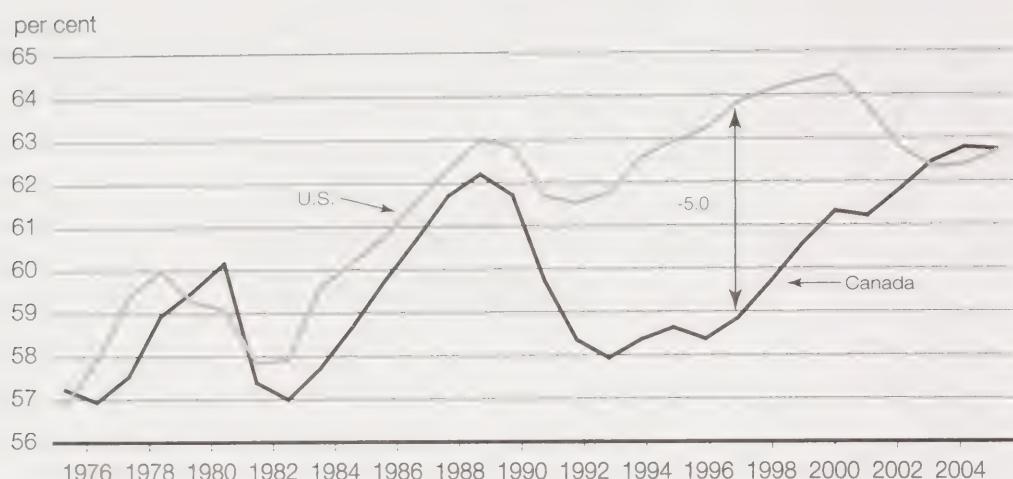


Sources: *OECD Economic Outlook*, No. 77 (June 2005); Statistics Canada; Bureau of Labor Statistics.

Canada's employment rate—the share of the Canadian population over the age of 15 with a job—has increased dramatically. The decline in the employment rate in the early 1990s contributed to Canada's poor living standards performance. In 1993 it stood at 57.9 per cent. Since then, however, healthy job growth has led to a strong increase in the employment rate, which reached a record high of 62.7 per cent in 2004.

The Canadian Employment Rate Reached a Record High in 2004

Employment Rate (Annual Averages)

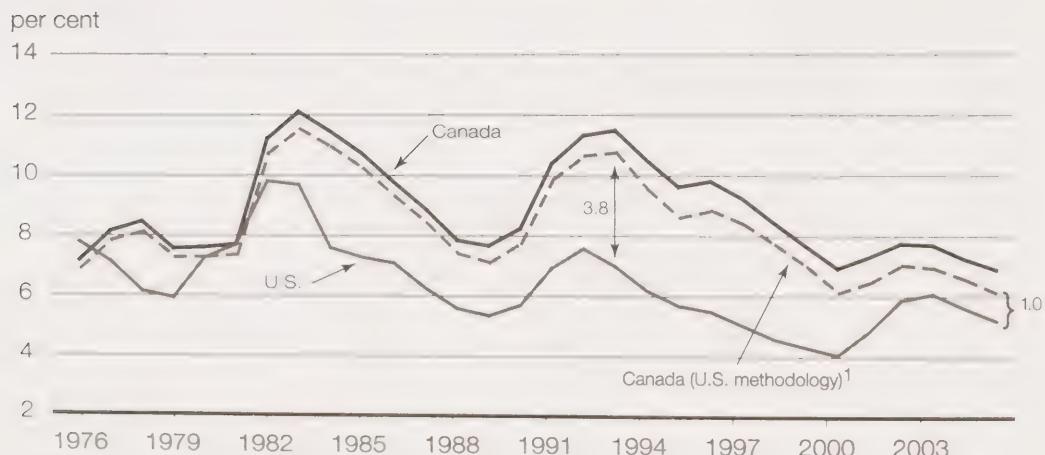


Sources: Statistics Canada, Labour Force Survey; Bureau of Labor Statistics, Current Population Survey.

Strong employment growth helped to reduce Canada's unemployment rate despite a rate of participation in the labour market that reached record highs by late 2003. In 1993 Canada's unemployment rate, adjusted to increase comparability with the U.S. rate, was nearly 4 percentage points higher than that of the U.S., but by 2004 the gap was only 1 percentage point.

The Canadian Unemployment Rate is at a 30-Year Low

Unemployment Rate (Annual Averages)



¹ See Statistics Canada, *Supplementary Measures of Unemployment*, Catalogue No. 71-005-XPB, p. 34.
 Sources: Statistics Canada, Labour Force Survey; Bureau of Labor Statistics, Current Population Survey.

The rebound in employment growth and the participation rate since the mid-1990s is especially evident among youth and older workers—the two groups hardest hit by the economic weakness of the early 1990s.

A healthier labour market meant that those who became unemployed did not remain so for as long. With more plentiful jobs, the average amount of time an unemployed worker spent looking for work fell by nearly 10 weeks between 1997 and 2004. Furthermore, about 85 per cent of the 2.6 million new jobs created between 1997 and 2004 were full-time positions.

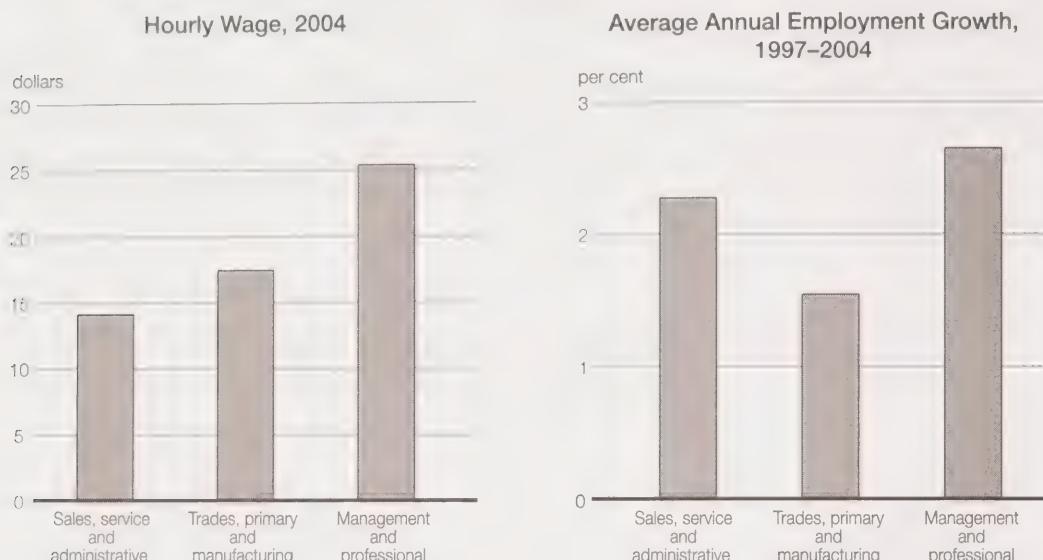
Most of the Jobs Created Are Full-Time



Source: Statistics Canada, Labour Force Survey.

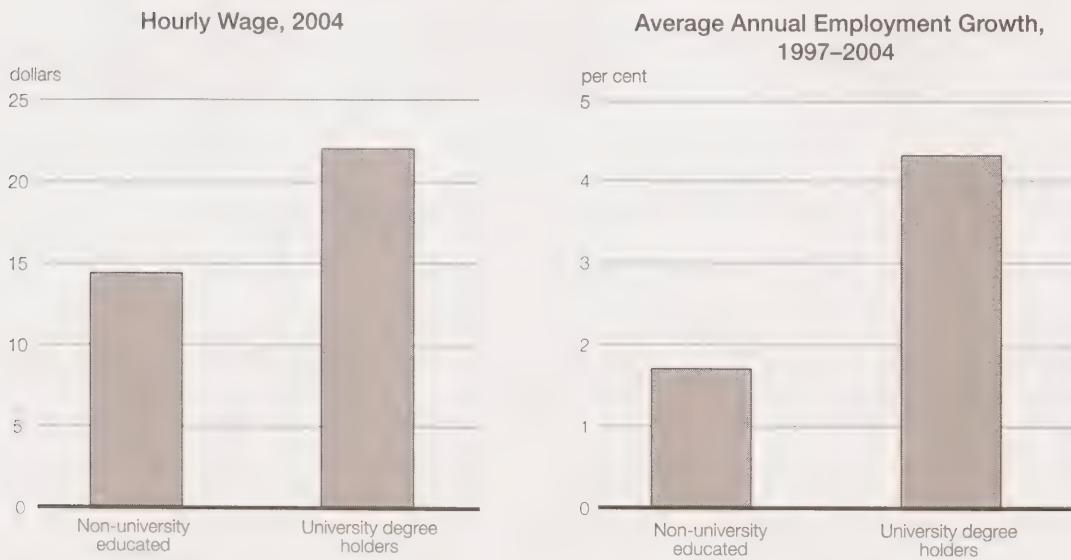
While this pickup in employment growth was widespread, growth was fastest among high-wage and high-knowledge occupations. Employment in management and professional occupations grew much more quickly than employment in trades and manufacturing, where jobs are generally less lucrative. As well, employment among people with university degrees has grown more than twice as fast as that of people with less education. This suggests that the economy is not only creating more jobs, but also creating better jobs than in the past.

The Fastest Rate of Job Creation Has Occurred in High-Wage Sectors



Source: Statistics Canada, Labour Force Survey.

Jobs in Canada Are Becoming Increasingly Knowledge Intensive



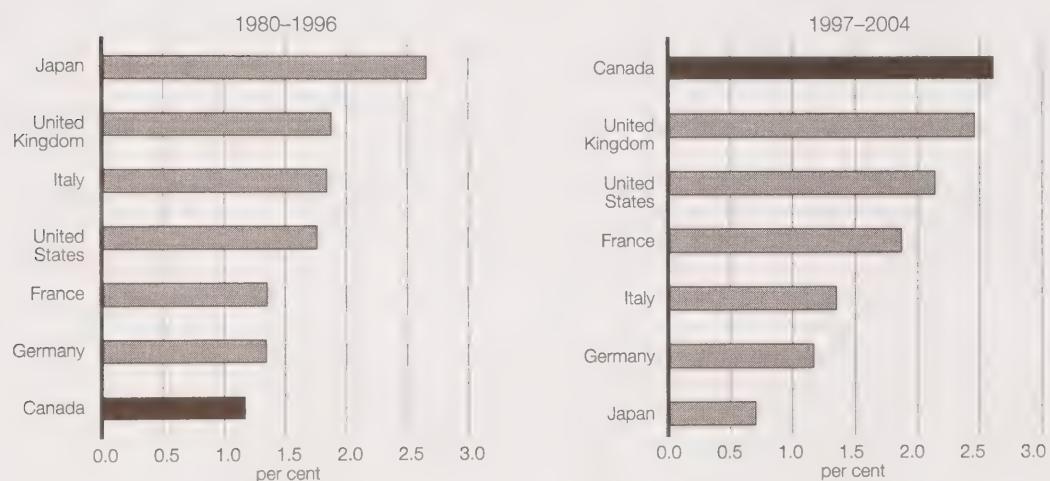
Source: Statistics Canada, Labour Force Survey.

Strongest Growth in Living Standards in the G7

Canadians' success in creating more and better paid jobs led to a strong rebound in the growth of real GDP per capita. Indeed, over the 1997–2004 period real GDP per capita growth was more than twice that of the period between 1980 and 1996. To put this improvement into context, the living standards of Canadians have increased more in the past 8 years than in the previous 18. Canada has moved from a laggard to a leader in living standards growth among our G7 peers.

From a Laggard to a Leader in Standard of Living Growth

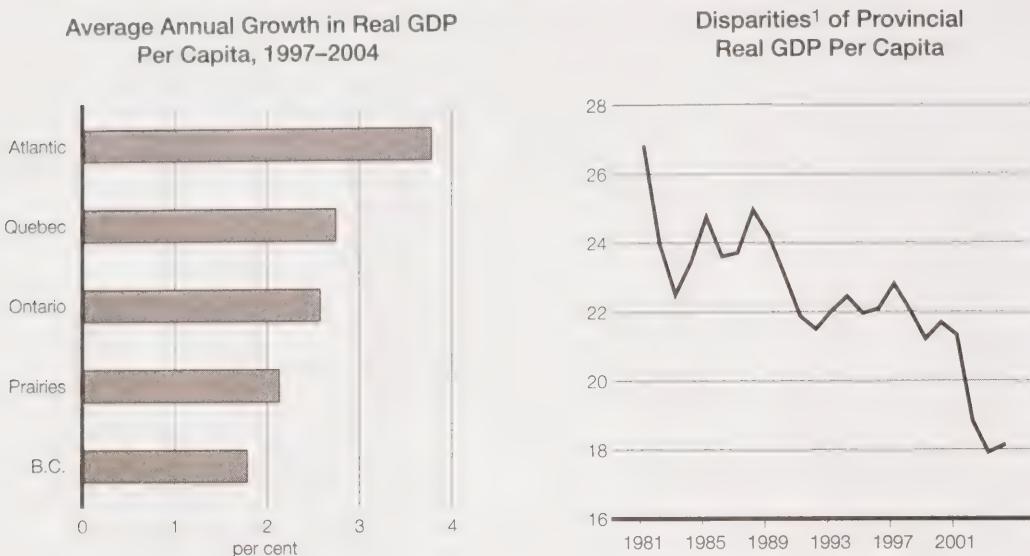
Average Annual Growth in Real GDP Per Capita



Sources: *OECD Economic Outlook*, No. 77 (June 2005); Statistics Canada; Bureau of Economic Analysis; Bureau of the Census.

Furthermore, all parts of the country have contributed to and benefited from this improvement in living standards. The largest increase in living standards occurred among the Atlantic provinces, further reducing economic disparities between regions of Canada, a trend which has now been observed for over two decades.

Growth in Living Standards Has Improved in All Regions of Canada

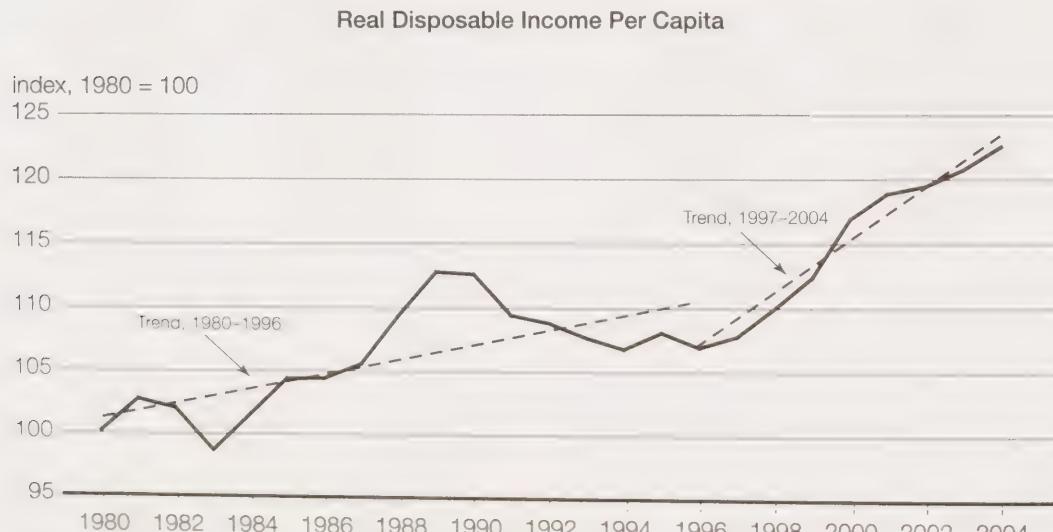


¹ Disparity refers to the coefficient of variation, which is the standard deviation of provincial real GDP expressed as a percentage of Canadian real GDP per capita.

Sources: Statistics Canada; Department of Finance Canada calculations.

Canadians have also witnessed an improvement in their take-home pay. Real disposable income per Canadian—the amount of income available after taxes to and transfers from government—grew three and a half times as fast per year between 1997 and 2004 than it had between 1980 and 1996. Real disposable income per person was \$2,700 higher in 2004 than in 1996, an increase of about 15 per cent. This rate of growth, sustained over a lifetime, would be sufficient to quadruple real disposable income.

Faster Income Growth for Canadians



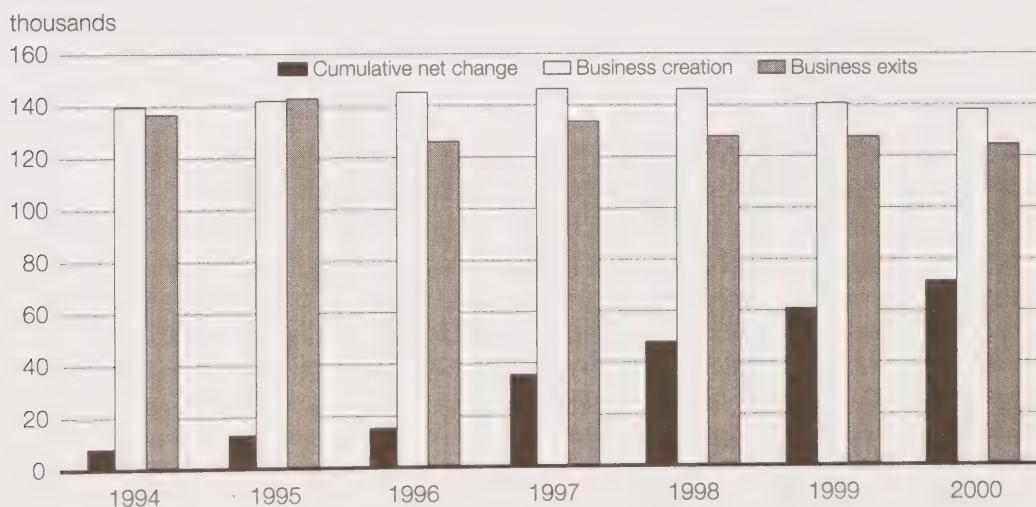
Source: Statistics Canada.

2. THE FLEXIBILITY OF OUR ECONOMY HAS BEEN CENTRAL TO JOB CREATION AND PROSPERITY

The long-term economic performance of a country is closely linked to its degree of flexibility and its capacity to adjust to changing economic circumstances. New firms created in expanding sectors drive faster employment and productivity growth as they replace firms with declining demand for their products or services. Through this evolution, a society constantly moves resources to where they can be used most effectively. The Canadian economy has shown considerable dynamism in recent years. For example, during the six-year period between 1994 and 2000, an average of 142,000 new businesses were created each year and about 131,000 closed, resulting in net new business creation of about 11,000 per year.

Workers from contracting firms and sectors of the economy are generally reabsorbed quickly into expanding ones. In fact, more than half of the Canadian jobs available in 2003 did not exist in 1997. In 2004 about 4 million workers, or more than one-quarter of the labour force, changed jobs, a testament to the degree of change constantly occurring in the economy and the adaptability of Canadian workers.

The Canadian Business Sector Continues to Adjust and Adapt



Sources: Statistics Canada, Longitudinal Employment Analysis Program; Department of Finance Canada calculations.

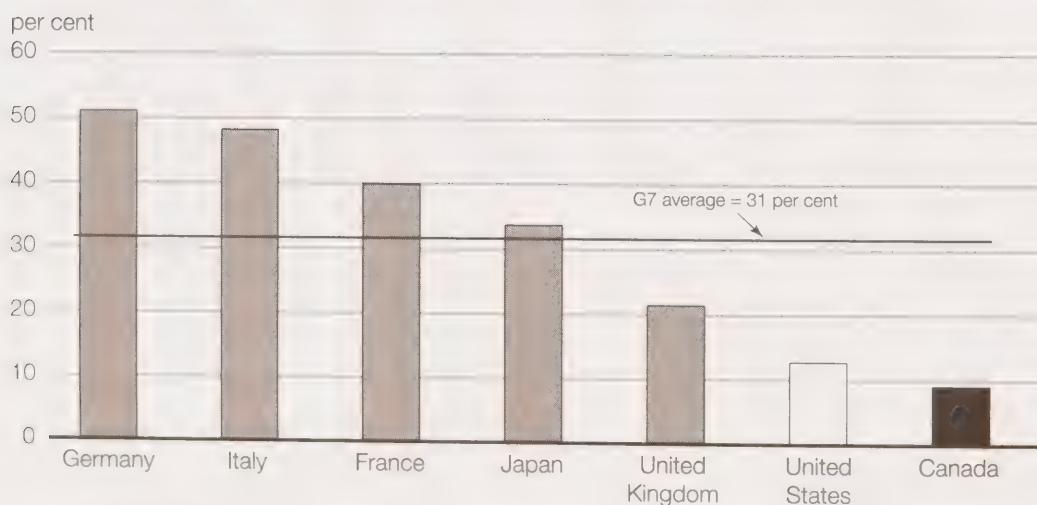
In order to succeed in the 21st century, Canadian output and employment will have to move increasingly to knowledge-intensive and highly skilled sectors. As noted earlier, not only did Canadian employment increase more quickly since 1997 than it did between 1980 and 1996, but also growth was fastest among high-wage and high-knowledge occupations. All major sectors of the economy are increasingly relying on highly skilled workers. Between 1990 and 2004, the share of those employed with post-secondary education increased in every major sector of the economy, including the primary sector where it has increased by close to 15 per cent. Indeed, nearly 50 per cent of those employed in the primary sector now have post-secondary education.

These trends indicate that the Canadian economy is adapting well to economic change. Service industries that have experienced superior employment growth, such as professional and business services, pay higher-than-average wages. As well, the Canadian manufacturing sector is increasingly specializing in the production of high value-added goods. As a result, while the relative share of manufacturing employment has declined, manufacturing's share of output has remained constant over the past decade and a half, as productivity improved. Faster productivity growth, in turn, drives higher average incomes and greater demand for goods and services. It is this process that has helped fuel the strong growth in Canadian output and employment observed over the past decade, as it should continue to do in decades to come.

Canada ranks well in economic flexibility, not only against European economies where labour and product markets tend to be more rigid, but also against the U.S. For example, Canadian workers who lose their jobs find new ones more rapidly than in other major countries, including the U.S.

Canadian Workers Are Also Highly Adaptable to Changing Economic Circumstances

Long-Term Unemployment as a Share of Total Unemployment, 2004



Source: OECD.

Canada's Economy Has Become More Resilient

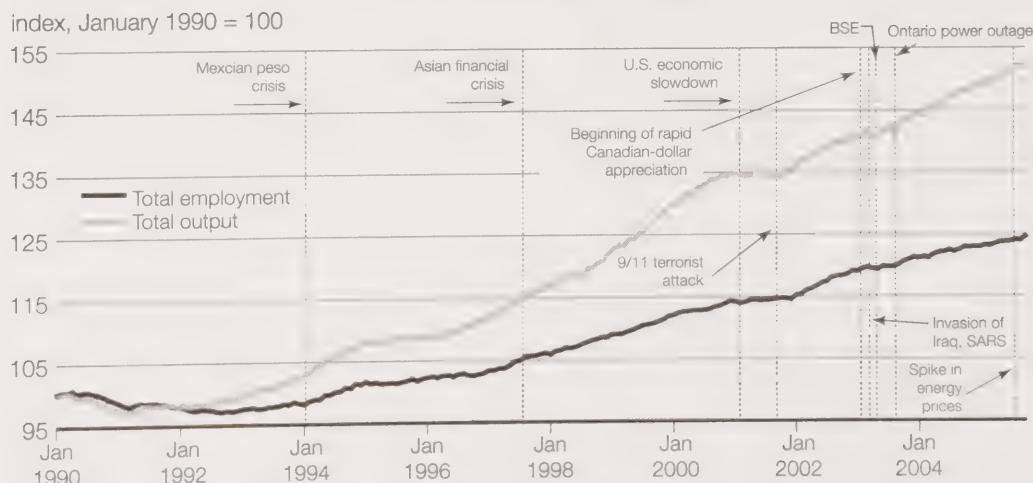
The resilience of the Canadian economy has been enhanced by a much-improved macroeconomic environment, higher levels of education and greater business investment. This greater resiliency has enabled our economy to weather shocks while maintaining healthy economic growth for more than 14 years, the second longest economic expansion on record. Despite external shocks such as the Asian financial crisis in 1997–98 and the slowdown in the U.S. economy in 2001, as well as domestic shocks including bovine spongiform encephalopathy (BSE), severe acute respiratory syndrome (SARS) and the Ontario power outage in 2003, output and employment in Canada have continued to expand at a healthy pace. The Organisation for Economic Co-operation and Development (OECD) recently acknowledged Canada's achievements, stating that "the Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well designed macroeconomic framework..."¹

More recently the appreciation of the Canadian dollar against the U.S. dollar has created challenges for firms with a high degree of exposure to international trade. However, businesses are demonstrating their continued ability to compete in the international marketplace. Looking ahead, recent increases in energy prices as well as the possibility of a further appreciation of the Canadian dollar driven by large and persistent U.S. current account imbalances could pose additional challenges for the Canadian economy. However, a healthy fiscal position and a much-improved macroeconomic framework have established a strong platform from which Canadians can meet these challenges.

A trade-dependant economy such as Canada's also faces potential disruption because of crime, terrorism or natural disasters. The Government will continue to make the legislative changes and investments required to strengthen the resilience of the economy by enhancing Canada's capacity with respect to security, emergency preparedness and readiness to cope with pandemic influenza.

Canada's Flexible Economy Continued to Expand and Create Jobs Despite Economic Shocks and Structural Changes

Output and Employment in Canada



¹ OECD, *Economic Survey of Canada* (2004).

Environmental Industry as a Growing Sector

The Canadian environmental industry, including services, manufacturing and construction, is an example of a sector that is growing rapidly in response to changing conditions. It has benefited from an increased demand for pollution control technologies and processes as firms increasingly strive for higher standards of environmental performance in light of concerns over climate change and air, water and soil pollution, as well as the ongoing need for energy efficiency.

Sales derived from environment-related activities grew from over \$11 billion in 1997 to almost \$16 billion in 2002. Over this same period the number of business establishments engaged, in whole or in part, in environment-related activities grew from 6,000 to 8,000. In 2002 Canadian environmental businesses earned \$364 million in revenues from the sales of advanced technologies to reduce greenhouse gas emissions, such as fuel cells, alternative fuel technologies, and solar and wind energy systems.

The environment and climate change are key priorities for Canadians, industry and the Government. Accordingly, the environmental industry can be expected to continue its impressive growth by making other industries more efficient and productive, while also helping them meet environmental standards and regulations.

3. AS A RESULT OF THIS PROGRESS, OUR COMMON FUTURE IS MORE SECURE

Only through integrated and complementary economic and social progress will we achieve our goal of strong and sustainable living standards growth along with a better quality of life. The improvement in Canada's economic performance, especially since 1997, has allowed the Government to make progress on tax competitiveness and fairness and to reinvest in a range of areas that contribute to our quality of life—health care, the environment, families and children, communities and security. By maintaining clear priorities through discipline and focus, much has been accomplished. The following highlights a number of the Government's initiatives in key policy areas.

Improved Economic Performance Has Allowed the Government to Make Key Reinvestments in Important Priorities

Health

The federal government, in partnership with provincial and territorial governments, is committed to strengthening Canada's publicly funded system of health care through:

- ✓ Direct federal support for health human resources, health promotion, disease prevention, public health, and performance reporting provisions that will complement provincial actions
- ✓ Creation of the Public Health Agency of Canada with a mandate to strengthen Canada's public health and emergency response capacity, and to develop national strategies for managing infections and chronic diseases
- ✓ September 2004 health accord
- ✓ 2003 First Ministers' Accord on Health Care Renewal
- ✓ An enhanced accountability framework to report to Canadians on the progress of reform

Environment

The Government is making major investments to preserve our natural environment and to address climate change, including:

- ✓ Climate Fund to further stimulate cost-effective actions to reduce or sequester greenhouse gas emissions in Canada
- ✓ EnerGuide for Houses Retrofit Incentive program for Canadians
- ✓ Green Municipal Funds for investments in innovative green municipal projects
- ✓ Wind and Renewable Power Production Incentives
- ✓ Enhanced tax incentives through accelerated capital cost allowance to encourage investment in efficient and renewable energy generation
- ✓ Funds to improve the ecological integrity of Canada's National Parks and the Great Lakes ecosystems and to preserve the health of Canada's oceans
- ✓ Funds to support the cleanup of contaminated sites.

Improved Economic Performance Has Allowed the Government to Make Key Reinvestments in Important Priorities (cont'd)

Communities and Culture

The Government has made a number of important strategic investments to strengthen safe communities and local economies and to encourage cultural diversity, including:

- ✓ Gas tax sharing with cities and communities and the goods and services tax rebate
- ✓ Funding for public transit infrastructure
- ✓ Affordable housing agreements with provinces and territories
- ✓ National Homelessness Initiative
- ✓ Funds for the Tomorrow Starts Today arts and culture package
- ✓ Investments to celebrate Canada and to help Canadian diversity find its voice in communities across the country
- ✓ Increased funding to Sport Canada

Families

The Government has made significant investments in support of Canadian families and their children including:

- ✓ Introduction of the Canada Child Tax Benefit and subsequent enhancements
- ✓ Early Learning and Child Care initiative
- ✓ Early Childhood Development Agreement to expand early childhood development programs
- ✓ Extended tax assistance for persons with disabilities and their families, including a new Child Disability Benefit
- ✓ Multilateral Framework for Labour Market Agreements for Persons with Disabilities
- ✓ Increased payments under the Guaranteed Income Supplement for low-income seniors
- ✓ Reforms to the Canada Pension Plan to ensure the plan's long-term sustainability

Canada and the World

The Government has introduced initiatives to ensure that Canada continues to meet its global responsibilities and to enhance personal and economic security through:

- ✓ Creating the International Policy Statement
- ✓ Largest funding increase for the Canadian Forces in 20 years to expand troops and reserves, support operations and acquire equipment
- ✓ Doubling international assistance by 2010–11 from its 2001–02 level
- ✓ Doubling aid to Africa by 2008–09 from its 2003–04 level
- ✓ A Canadian debt relief initiative for the world's poorest countries plus an additional contribution to the heavily indebted poor countries debt relief initiative
- ✓ Funds to combat diseases in developing countries, including through the Global Fund to Fight AIDS, Tuberculosis and Malaria, the Global Alliance for Vaccines and Immunization, and the Global Polio Eradication Initiative
- ✓ Creating the National Security Policy
- ✓ Providing funds to improve air and marine security, intelligence and policing, emergency preparedness and response, border security and border infrastructure
- ✓ Improving the integration and effectiveness of security functions
- ✓ Establishing a new Public Safety and Emergency Preparedness department

Challenges and Opportunities

The combination of emerging economic giants and widespread technology adoption is profoundly reordering the global economy. As a consequence, Canadian firms have unprecedented opportunities to penetrate massive new consumer markets and secure positions in the higher value-added segments of global supply chains. As we seize these opportunities, we must also address the challenge that our aging population poses for our economic and fiscal prospects.

For Canada to respond, all Canadians must be able to realize their full human potential. Specifically, everyone should have the opportunity to acquire the necessary education and skills to achieve personal fulfillment through work. No one should face insurmountable barriers or disincentives to work.

This fundamental commitment to fairness must be complemented by an improvement in our productivity performance. There are excellent reasons to be confident in our prospects, including our diverse and highly skilled population, openness to the world, immense resource potential and robust financial health. We can build these advantages further through a consistent economic policy framework that increases education, training and skills, capital accumulation and innovation.

1. AN UNPRECEDENTED GLOBAL OPPORTUNITY

The world economy is changing rapidly. Fast-growing emerging economies are increasing their share of global trade and output. Advances in information and communications technologies, lower transportation costs and reduced trade barriers are driving increased global flows of goods, services, capital and people. New business models are emerging, with production increasingly specialized and dispersed across countries. Greater international investment flows are also promoting the rapid spread of new products and knowledge, thereby accelerating economic expansion and increasing competition for skilled workers.

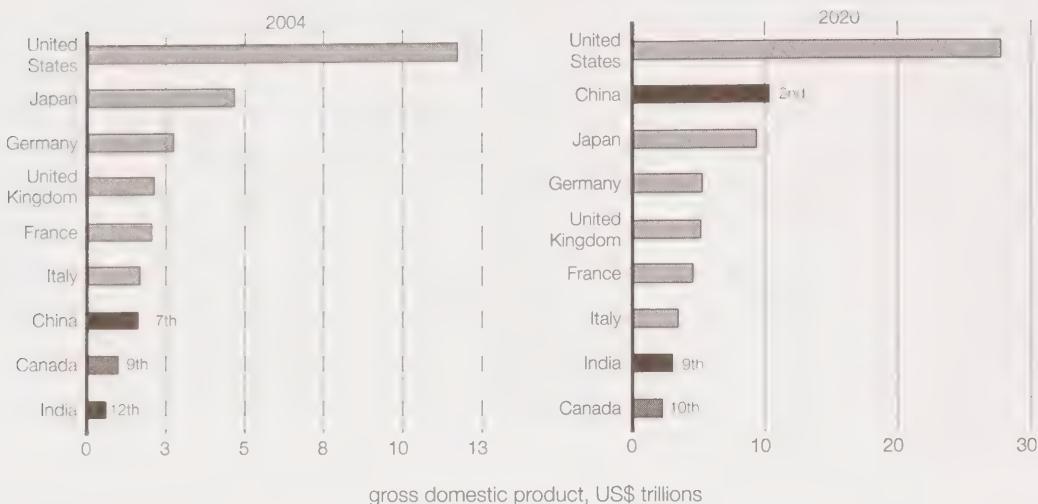
The Growing Importance of Emerging Economies

Emerging economic giants are now major factors in the global economy. The rise of China has been remarkable. Its economy has grown at 9 per cent a year on average for the past two decades and is now the world's seventh largest.¹ Based on current projections, China is expected to become the world's second largest economy by 2020, behind only the United States. India's share of the global economy is also increasing. India has been growing at 6 per cent a year and is now the world's 12th largest economy. By 2020, it could be the world's 9th largest, just ahead of Canada.

¹ These rankings of country sizes are based on market exchange rates. While purchasing power parity estimates are best suited for international comparisons of living standards, market exchange rates are more appropriate for assessing the relative importance of a country in the global economy, because they measure the ability of an economy to pay for goods and services from other countries.

Economic Activity Is Shifting to Rapidly Growing Emerging Economies

World's Largest Economies



Note: Not shown: 2004: Spain (8th), South Korea (10th) and Mexico (11th); 2020: Russia (8th).

Source: Global Insight.

China and India have also had a dramatic impact on world trade patterns. In 2003 China's exports surpassed those of Japan, making it the third largest global trader after the United States and Germany. Export growth of Chinese manufacturing goods has averaged almost 20 per cent a year for the past 10 years. While China mostly exports labour-intensive goods such as apparel, textiles, footwear and toys, its exports of office machinery, telecommunications and industrial supplies have also grown rapidly in recent years.

Although India's share of world trade is still relatively small, its service exports have grown as rapidly as China's manufacturing exports, though from a much smaller base. Increasingly, India specializes in providing commercial services to Western companies looking to outsource business processes, such as call centres, back-office operations, data entry and computer programming. This dynamic creates cost-saving opportunities for Canadian firms that can then reinvest in higher-value operations here at home.

China's Goods Exports and India's Service Exports Are Growing Rapidly



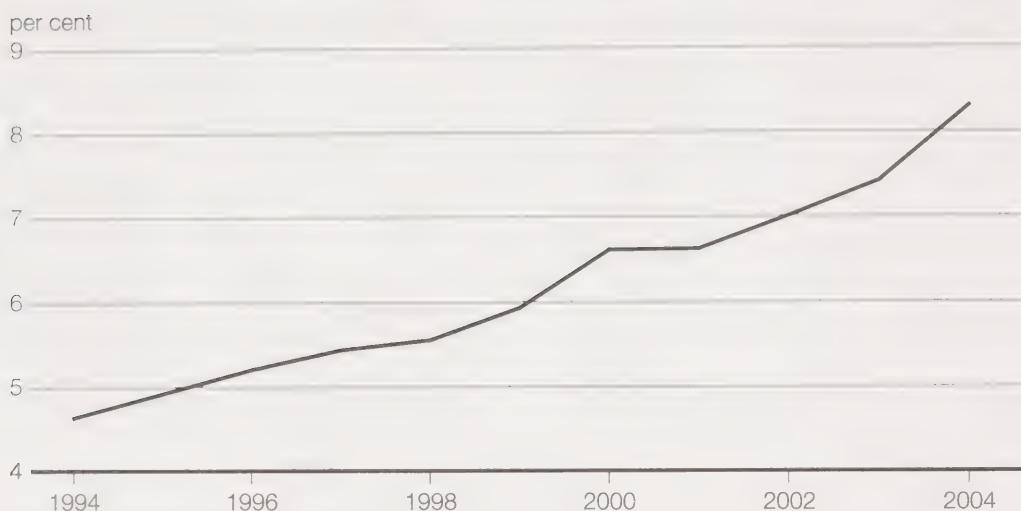
Source: World Trade Organization.

The pace of the integration of China and India into the world economy mirrors the rise of Japan in the 1960s and 1970s, and that of the newly industrialized Asian economies during the 1970s and 1980s. However, the key difference with China and India is scale. The newly industrialized economies of Asia and Japan accounted for only 4 per cent of the world's population when they emerged on the world stage. By comparison, China and India together account for almost 40 per cent of the world's population. While the majority of people in China and India still live in rural areas, tens of millions of new workers are absorbed into urban centres each year. The average skill level is increasing rapidly. For example, China and India together graduate about 400,000 engineers a year. In short, today's emerging giants have the potential to significantly magnify the impact of similar changes experienced during past decades.

Emerging Asian giants are having a major impact on global commodity markets. To support their rapid growth, China and India have sharply increased their demand for natural resources and related products. China is now the world's largest user of steel, copper and iron ore, and recently surpassed Japan as the world's second largest oil consumer, accounting for 8 per cent of world demand. Its effect on the margin and therefore on the global balance of demand and supply is even more dramatic. China accounted for more than 35 per cent of the increase in world oil demand in 2004, more than all countries in the OECD combined. This sharp increase in demand from China not only reflects its rapid growth, but also an oil intensity that is more than double the OECD average. This strong demand for resources and energy has put upward pressure on global commodity prices, particularly oil prices, and is expected to continue to do so in the future. As discussed in the next section, Canada should be a major beneficiary of this growth in demand for natural resources, alternative energy sources and environmental technologies.

Rapid Growth of Emerging Economies Is Having a Marked Impact on World Commodity Market

Per Cent of World Oil Demand Coming From China



Source: BP, *BP Statistical Review of World Energy* (2005).

Seizing Opportunities in a Dynamic Global Economy

An increasingly dynamic global economic environment provides many opportunities for Canadians. For example, the rise of China and India has increased demand for our exports, particularly natural resources and capital goods. Moreover, the combination of technological advances and these growing markets creates the opportunity to position ourselves in higher value-added parts of global supply chains.

As discussed in the following box, Canada's resource sector stands to gain immensely. As emerging economies continue to develop, their demand for resources and energy will grow. In addition to providing export opportunities, strong Asian demand for resources and energy puts upward pressure on commodity prices. As a net exporter of resources, this implies a large net wealth gain for Canada.

Canada's non-resource trade with emerging markets is also increasing. China is the second largest source of our imports after the United States. It has become our fourth largest export market and our exports to China should continue to expand rapidly. Canada's merchandise exports to China have grown at an average annual rate of 20 per cent since 1999. China now receives 1.6 per cent of Canadian exports, compared to 0.7 per cent in 1999. Moreover, Canadian export growth to China has been slightly faster than that of the United States over this period.

The Rise of Emerging Economies Bodes Well for Canada's Resource Sector

Canada's rich natural resources and the industries they support are a vital part of our economy. This sector—forests, energy, minerals and metals, as well as related industries—accounts for 13 per cent of Canada's GDP, represents more than 40 per cent of Canadian exports and employs slightly more than 1 million Canadians. More recently energy consolidated its place as Canada's leading resource export sector. In 2004 energy exports reached a record \$66 billion, driven by higher prices and new sources of supply. With rising oil prices in recent years, the share of energy in exports has more than doubled from 7.3 per cent in 1998 to 16.1 per cent in 2004.

The Canadian resource sector is very capital-intensive, competitive and innovative. It is a diverse sector, well poised to benefit from a growing world need for alternative sources of energy, environmental technologies and the increasing interest in nuclear energy. Over the past decade, fully one-third of total investment in the Canadian economy has taken place in the natural resource sector, boosting gross capital stock by more than \$400 billion since 1994. Over half of this expansion was in oil and gas, including megaprojects such as Hibernia, Terra Nova and Sable Island, and the Alberta oil sands. The non-conventional oil extraction industry, buoyed by prices that help the feasibility of many new projects, is the largest contributor to growth in the mining and oil and gas sector. The level of investment in the oil sands rose from \$400 million in 1994 (or less than 4 per cent of investment in conventional projects) to \$8.5 billion in 2005 (or 26 per cent of investment in conventional projects).

With its abundance and variety of natural resources, Canada is well positioned to take advantage of export opportunities arising from China and India's development and strong growth. Notably, Canada has a huge recoverable supply of crude oil and natural gas for future development. Crude oil reserves in 2002 were estimated at about 180 billion barrels, consisting of conventional oil (about 5 billion barrels) and oil sands (about 175 billion barrels). Today's annual oil production in Canada is about 940 million barrels, implying that the proven reserves could last almost 100 years even if the current rate of production were to double. Moreover, the ultimate recoverable potential from the Alberta oil sands is more than 315 billion barrels. The ultimate potential of Canadian natural gas supplies is estimated at nearly 600 trillion cubic feet, enough to last 100 years at current rates of production.

Nevertheless, Canada has a market share of just over one per cent of total Chinese imports. Similarly, our direct investments in China account for only one per cent of our total stock of investment abroad. We need to make a much bigger and stronger effort to build better economic relationships with China. Canadian firms are well positioned to expand their presence substantially due to our high-quality workforce, diaspora relationships, expanding physical trading networks and sophisticated service industries, which complement our strength in natural resources.

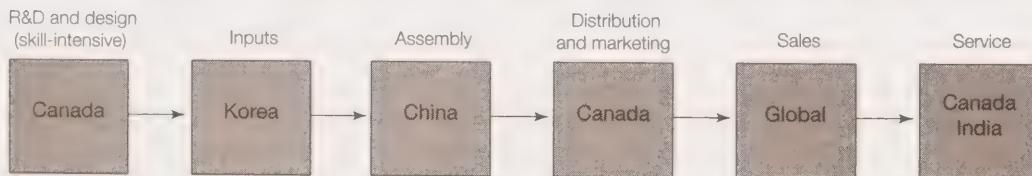
Technology Is Facilitating New Business Models

The combination of technology-driven reductions in transportation and communication costs and lower trade barriers have helped to create new business models, thereby changing the organization of global production and the shape of the international economy. Production processes have become increasingly international and dispersed; countries specialize in particular stages of production according to their comparative advantage. Global supply chains link these processes to deliver final products and after-sale services to the end consumer. Whereas in the past, products were produced and assembled in one particular country before being shipped to the final user, manufactured goods are increasingly being subdivided into many components that are produced in different countries before being assembled (often in yet another country) and shipped to their final destination (see following box). This trend has been reinforced by positive developments in emerging markets that have made the foreign provision of certain goods and services more economically viable.

Businesses Are Becoming More Globally Integrated

Examples of the “global supply chain” can be found in a wide range of industries, from textiles and toys to computers and telecommunication equipment. In each case, the common principle is to produce the different components of a final product where it is most cost-advantageous to do so. Consider the example of a computer hardware component, such as a video card. The R&D can be performed in Canada, the different inputs manufactured in Korea and the final product assembled in China. The product can then be distributed out of Canada and sold to customers situated around the globe, while the after-sale service can be done in Canada or increasingly in India. The physical location of production matters less now than it did just 10 years ago. What matters is the comparative advantage of the different businesses involved in the global production chain. For Canadian prosperity, it matters that our firms are linked into such chains, particularly in the highest value-added components.

Example of the Global Supply Chain: Computer Hardware Component Manufacturer



Increasing Trade in Services

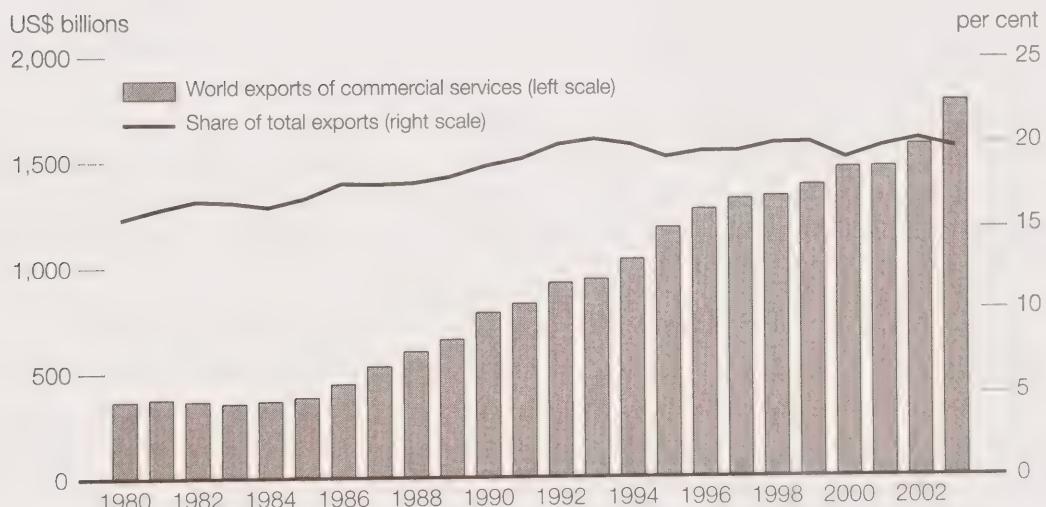
The globalization of trade is now spreading to the largest sector of the economy—the service sector. The same conditions that led to global supply chains for goods are now in place for services, as new technologies have greatly reduced the cost of transmitting data quickly to almost anywhere around the globe. The digitization of information has allowed a broad range of service functions to be performed remotely.

The increasing importance of services in advanced economies has allowed for greater specialization, so that knowledge work has become more modular and can increasingly be divided in multiple tasks to be “assembled” in a final product. Managers and companies have gained the knowledge and experience necessary to make vertical specialization beneficial for a wide range of services.

Through this process, companies are increasingly shifting service-sector activities to where costs are the lowest. Not only are activities being outsourced to other companies domestically, but also parts of the supply chain are increasingly located in other countries, or “offshored” either to an independent foreign firm or to a firm’s foreign-based affiliate. As a result, trade of commercial services has grown rapidly over the past decade. This trend can be expected to continue.

Services Are Increasingly Traded Along With Goods

World Commercial Services Trade



Source: World Trade Organization.

New emerging economies participate in this shift towards the globalization of services. India in particular, with its large pool of English-speaking and well-educated young people, has developed a niche in providing commercial services to companies looking to outsource easily separable information-based business processes. In years to come, similar workforce capacities are expected to come from other emerging economies, such as the Philippines and South Africa.

Increased Importance of Foreign Direct Investment and Skilled Workers

Foreign direct investment (FDI), both inward and outward, promotes the diffusion of new technologies, creates jobs and generates trade. It helps develop supply chains, service foreign customers and make businesses more efficient.

The sharp rise in FDI over the past two decades illustrates the extent to which businesses have become more globally integrated and production more dispersed. Over the past two decades, the world FDI growth rate was more than double that of world trade. The accumulated stock of world FDI nearly tripled in the 1980s and rapid growth continued during the 1990s, reaching US\$8 trillion by 2003. Greater international investment flows are supporting the growth of global commercial networks and the rapid spread of new products and knowledge across countries.

Advances in technology and increased openness to trade have made it easier for investment to go anywhere in the world. With the emergence of global supply chains, investment that requires the intensive use of low-skilled labour will flow to a different location than investment that relies on high-skilled, knowledge-intensive workers and specialized infrastructure. These trends will intensify competitive pressures between countries for investment and skilled workers.

Canada must take maximum advantage of the integration of emerging economies into the world economy. In a world in which economic activity is increasingly flexible, divisible and specialized, taking advantage of cost-saving opportunities abroad and strengthening our advantage in high-knowledge activities will be key in order to succeed and attract the best jobs. While we cannot predict the future—in fact, because we cannot—we must continue to improve our ability to adjust to the opportunities provided by a rapidly changing global economic environment. With an open and diverse economy and abundant skilled people and natural resources, Canada is well positioned to take advantage of these opportunities.

2. THE CHALLENGE OF POPULATION AGING

As the world economy continues to evolve, Canada's demographic landscape will also change markedly. In particular, baby boomers will soon begin to retire in large numbers. Currently, there are more than five people of working age (15 to 64) in Canada for every person of retirement age (65+). Within the next 15 years, this ratio is projected to fall to four to one, and to be less than two and a half to one by 2050. Population aging will be a major challenge for all industrialized countries and Canada in particular. In fact, Canada is expected to experience the third largest increase in its ratio of elderly to the working-age population among G7 countries over the next 25 years and the sixth largest among OECD countries.

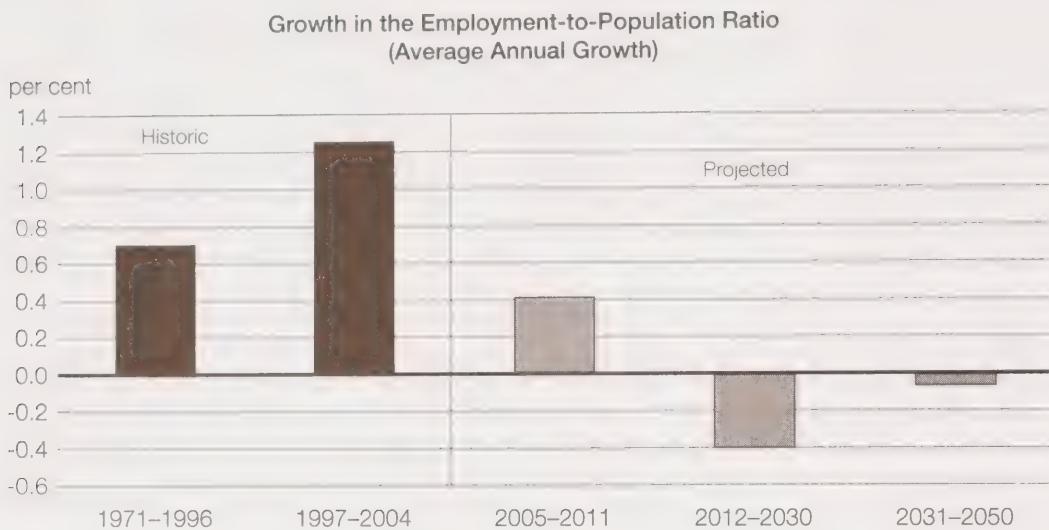
The aging of our population will exert upward pressure on age-related government spending, such as health care and public pensions. The reduction of the public debt burden over the last 10 years and the 1997 reforms to the Canada Pension Plan have positioned Canada well relative to most other G7 countries to cope with emerging demographic pressures. However, more is required to create the economic flexibility needed to address these impending pressures. Most importantly, we need to foster strong economic growth—the primary source of society's capacity to pay for public services.

Canada Is One of Few Countries With a Sustainable Public Pension System

The Canada Pension Plan and the Quebec Pension Plan (CPP/QPP), funded through payroll contributions, ensure a basic level of earnings replacement in retirement for all working Canadians. Given the outlook of a growing aged population and proportionately smaller workforce in future years, in 1997 Canada's federal and provincial governments agreed on a series of reforms to the CPP/QPP system. This package included not only changes to the plan's financing, achieved through a combination of contribution rate increases, cost savings and a new investment policy, but also significant changes to plan governance and accountability to ensure its ongoing financial health. For example, the CPP Investment Board was created as an arm's-length body to invest CPP funds, delivering an average nominal rate of return of more than 7 per cent a year over the last five years.

According to the *21st Actuarial Report on the Canada Pension Plan* released in 2004, the 1997 reforms have ensured the sustainability of the CPP for at least the next 75 years. Canada is one of very few countries with a financially sustainable public pension system. These reforms have therefore helped ensure that future generations of Canadians will avoid disruption in their living standard during retirement.

Smaller Share of Population Working May Slow Improvements in Living Standards



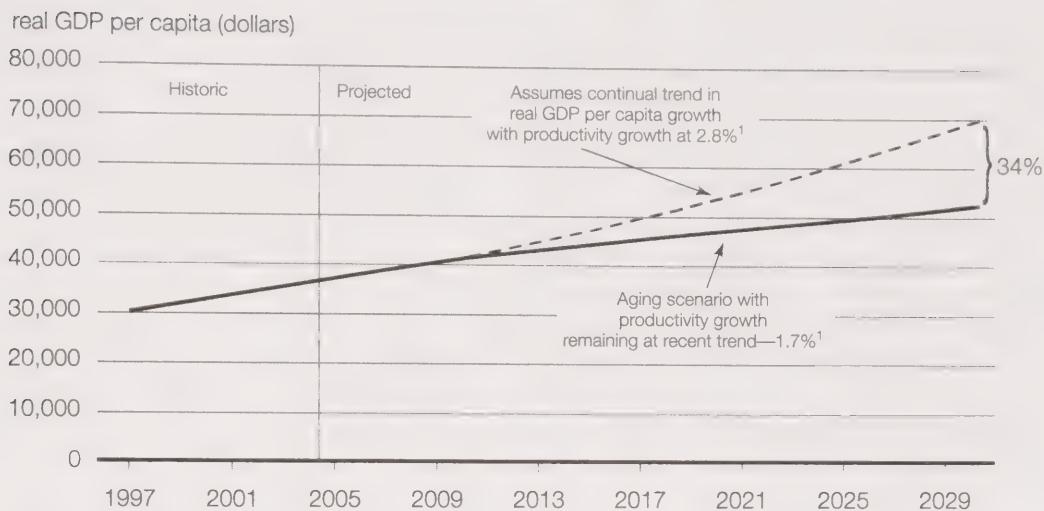
Source: Department of Finance Canada calculations.

However, sustaining strong economic growth in the years to come will in itself pose a major challenge. As the baby boomers retire, smaller cohorts of workers will replace them; the share of the population that is working is projected to decline after 2011. This expected fall in the employment-to-population ratio will exert significant downward pressure on potential growth of living standards in Canada. Over the last eight years, increases in the employment-to-population ratio contributed close to one-half of recorded improvements in Canada's GDP per capita. This will not be the case in the decades to come. In fact, the projected decline in Canada's employment-to-population ratio is expected to subtract as much as 0.4 percentage points on average from our future annual growth in real GDP per capita between 2012 and 2030.

To illustrate further the possible direct impact of impending demographic change on Canada's living standards, consider two scenarios. In the first scenario, we assume that the employment-to-population ratio falls by an average of 0.4 per cent a year after 2011, while productivity continues to grow at the average rate recorded since 1997. This scenario can be thought of as an "aging scenario" with productivity growth remaining at the recent trend of 1.7 per cent per year. In the second scenario, productivity growth increases from 1.7 per cent to 2.8 per cent to maintain growth in living standards at the pace experienced since 1997 despite the fall in the share of the population working. In this latter scenario, living standards would be as much as one-third higher by 2030, or about \$20,000 per Canadian in today's dollars, relative to the aging scenario.

Population Aging May Slow Improvements in Living Standards

Two Scenarios for Growth in Living Standards



¹ Both scenarios assume that the employment-to-population ratio declines steadily by 0.4 per cent per year on average after peaking in 2011. In the aging scenario, productivity growth remains at the 1997–2004 average of 1.7 per cent, while in the other scenario, it increases to 2.8 per cent, allowing growth in GDP per capita to remain at the 1997–2004 trend.

Source: Department of Finance Canada calculations.

The expected decline in the share of Canadians working is inevitable. To limit the decline, we must ensure that all Canadians who are willing and able to work have the opportunity to do so. Participation in the workforce remains a challenge for a number of Canadians, including Aboriginal people, persons with disabilities, recent immigrants and older workers. Canada's Aboriginal people and immigrants will be important sources of labour force growth, especially if their employment rates can be raised to the national average. Similarly, the labour force participation of older Canadians, which has increased significantly since the second half of the 1990s, remains below corresponding rates in Japan, the U.S. and most Nordic countries. As discussed in Chapter 4, the challenge will be to increase the labour force participation of these groups to help reach our full economic and social potential.

Increasing Canada's employment-to-population ratio may help to alleviate the challenge of an aging population, but it will not be a panacea. To illustrate: raising the employment rate of Aboriginal people and immigrants to the national average, while a significant social and economic achievement, would increase Canada's average GDP per capita by less than 3 per cent and close only about one-sixth of the current Canada-U.S. GDP per capita gap. As we move forward, the demographic challenge facing Canada reaffirms the importance of fostering robust productivity growth to ensure continued improvements in our living standards for years and decades to come.

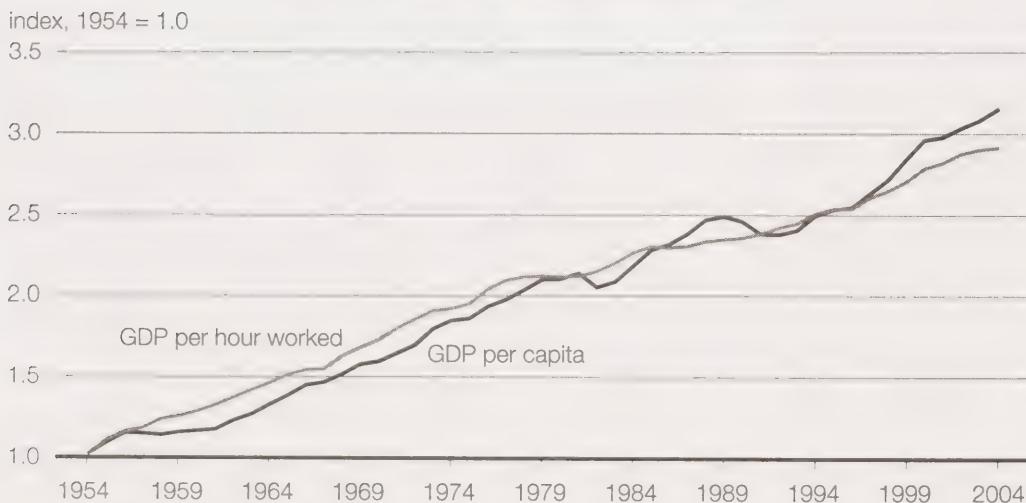
3. CANADA'S PRODUCTIVITY CHALLENGE

To address our changing demographics and seize global opportunities, Canada needs to focus on improving productivity. As discussed in Chapter 1, being more productive means working smarter, not working harder or longer hours (see box entitled "Productivity Growth Improves the Quality of Life in Many Ways" below). A more productive economy creates more and better jobs for Canadians.

In the long run, productivity—defined as total economic output (GDP) per hour worked—remains the fundamental driving force behind living standard improvements. Canada's economic success in the postwar period was driven by high productivity growth that supported a very rapid increase in the number of jobs and level of wages. Strong productivity growth drives Canadians' incomes higher; weak productivity growth undermines the economy, reducing the number of jobs and wealth. Over a long period, we can see from Canada's experience how important productivity growth has been in supporting our living standards. Over the last 50 years, Canada's GDP per capita has increased more than three-fold, primarily due to productivity growth.

In the Long Run, Productivity Growth Is the Key Source of Improvement in Living Standards

GDP Per Capita and GDP Per Hour Worked



Sources: Statistics Canada; Department of Finance Canada calculations.

Canada's productivity performance has improved significantly since 1997. Our average annual productivity growth increased from 1.1 per cent between 1980 and 1996 to 1.7 per cent between 1997 and 2004. Although this turnaround has been impressive, our productivity growth and level still lag behind those of the United States and most other G7 countries (see chart below).

Productivity Growth Improves the Quality of Life in Many Ways

Average Weekly Hours Worked, Canada

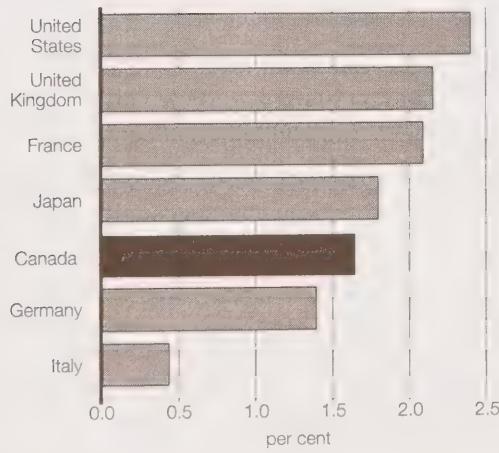
Increases in productivity lead to a better quality of life through higher living standards and wages, but also through other channels. For example, over the last 45 years in Canada, higher productivity contributed to a significant reduction in workweek length, allowing more time for leisure, recreation, and to spend with one's family. In fact, the average workweek has fallen from more than 39 hours in the early 1960s to less than 34 hours in 2004.



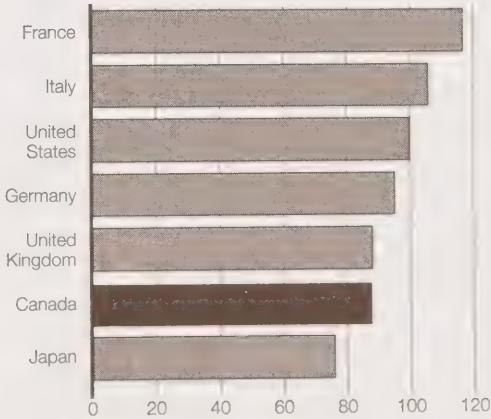
Source: Statistics Canada.

Canada's Productivity Performance Lags That of Most Other G7 Countries

Average Annual Productivity Growth¹ 1997–2004



Relative Productivity Level¹ 2004 (U.S. = 100)

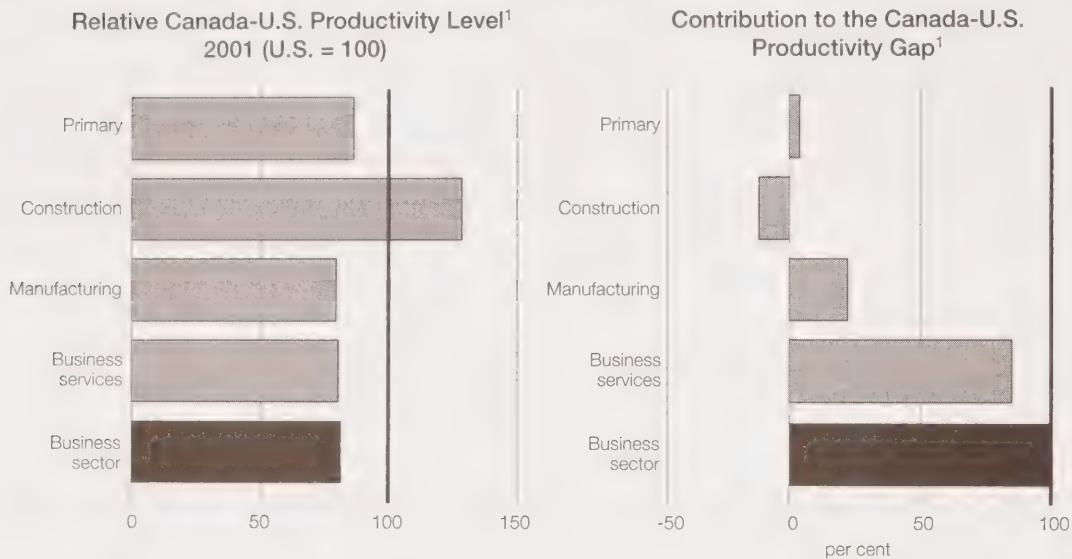


¹ Productivity is GDP per hour worked.

Sources: *OECD Economic Outlook*, No. 77 (July 2005); Statistics Canada; Bureau of Economic Analysis; Bureau of Labor Statistics.

Furthermore, Canada's lower productivity level vis-à-vis the United States is not located in a few sectors, but is widespread across industries. As the largest segment of the economy, the service sector contributes the most to our productivity gap with the United States. However, all other major sectors of the Canadian economy, with the exception of construction, are also less productive.

Canada's Productivity Levels Are Lower in Most Sectors

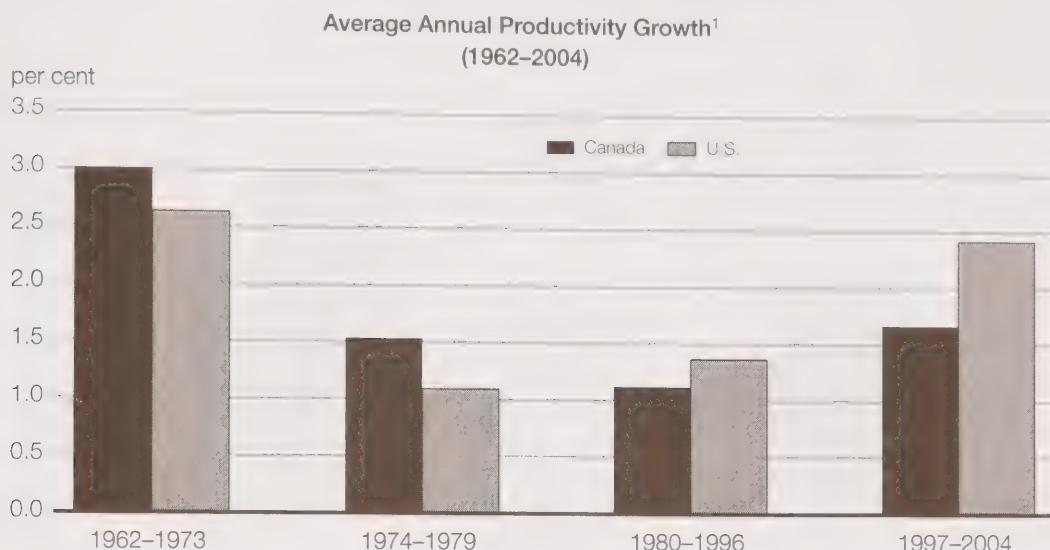


¹ Productivity is GDP per hour worked for the business sector.

Source: Someshwar Rao, Jianmin Tang and Weimin Wang, "Measuring the Canada-U.S. Productivity Gap: Industry Dimensions," *International Productivity Monitor*, No. 9 (2004).

At the economy-wide level, there were periods when Canada outperformed the United States in productivity growth, namely during the 1960s and 1970s. This shows that Canada can match and outperform the most competitive economy in the world in productivity growth.

Canada's Productivity Performance Has Outperformed That of the U.S. in the Past



¹ Productivity is GDP per hour worked.

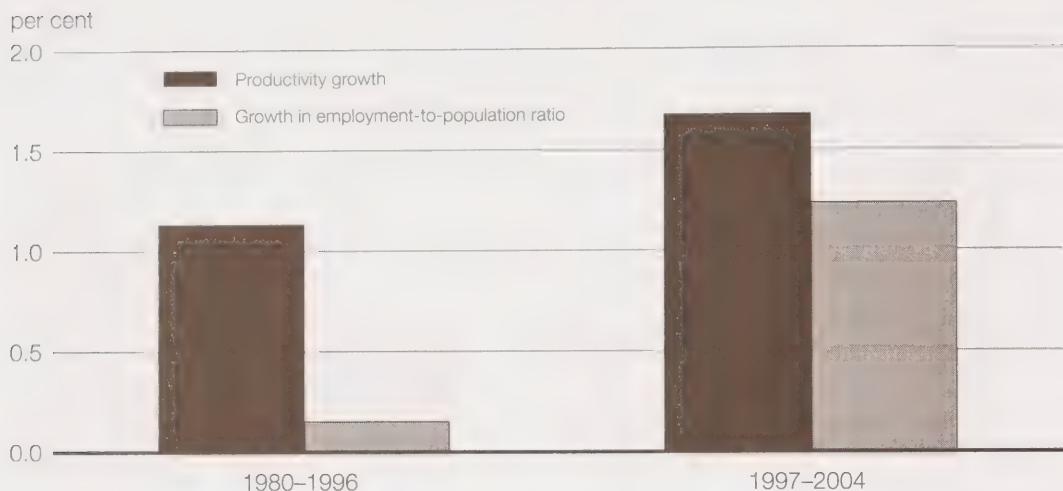
Sources: Statistics Canada; Bureau of Economic Analysis; Bureau of Labor Statistics.

Building the right conditions for improved productivity performance creates the conditions for more and better jobs. Indeed, Canada's performance since 1997 provides a good example of how improving the policy environment leads to both higher productivity growth and stronger job creation (see chart below). As discussed in Chapter 2, the combination of strong employment and productivity performance since 1997 has contributed to Canada's superior performance in living standards growth among all G7 countries. Looking ahead, advances in the inclusiveness of our workforce, the education and mobility of Canadians and strong productivity growth should translate into more Canadians having opportunities for higher-quality and well-paying jobs. The contribution and earnings of skilled workers can also be further enhanced by investments in physical capital and the efficacy of the workplace.

In summary, to meet the challenge of an aging population and to seize opportunities in the new global economy, Canada needs to improve its productivity performance. Higher productivity is not an end in itself but the means by which Canadians will reach a higher quality of life. We need to take greater advantage of the latest technologies, as well as invest more in our people and their skills. This course of action will lay the foundation for continued economic and social progress over decades to come.

Higher Productivity Growth Means More and Better Jobs

Productivity and Employment-to-Population Ratio,
Average Annual Growth



Source: Statistics Canada.

The Sources of Productivity Growth

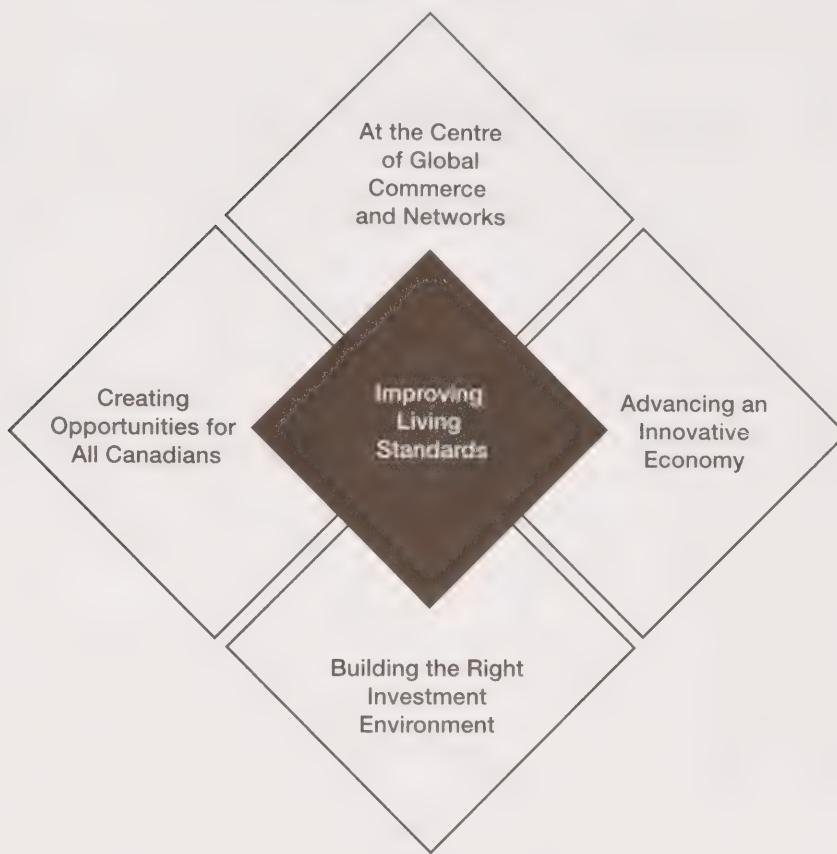
A five-year study by the OECD, *The Sources of Economic Growth in OECD Countries*, identified greater investment in education, physical capital and innovation as the key factors for creating a higher standard of living.

The performance of individual economies shows that greater investment in any single element, though important, will not ensure strong economic growth. For example, workers with advanced education perform research and development in public and private sector laboratories that produce new ideas. A range of workplace and marketplace innovative activities, and skilled workers, are needed to turn these new ideas into novel products and services, including new machinery and equipment, that enter and succeed in the marketplace.

A successful economy generates new jobs, economic growth and wealth when its performance in each of the elements is strong. Because the sources of growth complement and build on each other, fostering long-term productivity growth requires a policy agenda that encourages both their development and their interaction.

The following chapters discuss the four pillars of the Government's framework for improving productivity, living standards and prosperity.

A Medium-Term Framework for Raising Living Standards



"Creating Opportunities for All Canadians" focuses on the first pillar of Canada's economic prospects—a world-class workforce. Building this capability starts with investments in early childhood development, through post-secondary education, workplace training, and retraining. Even though Canadians are among the most highly skilled workers in the world and currently enjoy a very high employment rate, too many people are still not ready for the high-skill, high-wage jobs of the future. Highly educated workers enable firms to compete and attract foreign investment. Ensuring the active participation of all Canadians in the labour force, including immigrants, people with disabilities, older workers and Canada's Aboriginal people, becomes increasingly important for meeting the challenges of an aging population.

“Advancing an Innovative Economy” addresses the pressure on firms to be innovators, and to take advantage of global changes and the ever-increasing pace of technological progress. Canada must be a leader in technology development, adoption, adaptation and innovation. We start from a strong foundation in basic research leadership in our universities, which we must maintain. While we have improved our commercialization performance, we must become better at converting public research into business innovation and success. The role of the private sector is central in having an innovative economy, and here Canada’s performance has been mixed. Looking ahead, it will be crucial for the Government to ensure the right conditions exist for Canadian firms to invest more in research and development, innovation and productivity-enhancing machinery and equipment.

“At the Centre of Global Commerce and Networks” takes stock of our current status as a leading trading nation and addresses how we can add to this advantage. The openness of Canada’s marketplace has improved growth and living standards at home. Better global communications networks and transportation infrastructure are increasing competitive pressures on firms, creating new possibilities for trade and investment, and integrating production in global supply chains. Businesses that have a global mindset can benefit from these trends. Our ability to be at the centre of these developments depends on government initiatives to reduce barriers to the flow of goods, investment, ideas and people, to facilitate foreign investment, and to enhance the transportation and communications networks that link Canadians to opportunities in the global marketplace.

“Building the Right Investment Environment” examines the role of government policy in supporting Canada’s economic performance. The strategy responds to the reality that a globally integrated economy enables workers, businesses and investors to move toward regions and countries of their choice. Sound macroeconomic conditions, a fair, competitive and efficient tax system, appropriate regulations, efficient and dependable capital markets and financial institutions, and more productive government will position Canada as a country of choice for individuals, businesses and investors. Our high quality of life, strong social programs, social cohesion, tolerance and cultural diversity all help to secure these advantages.

Creating Opportunities for All Canadians

OVERVIEW

A highly skilled, educated and flexible labour force, is a prerequisite for success in today's knowledge-based economy. Canadians value education and our post-secondary education attainment rates are already high by international standards. We can remain ahead of the curve by continuing to increase our education and skills. In short, we must make the most of the skills and talents of all Canadians and ensure there is opportunity for all to contribute to, and share in, Canada's future prosperity.

We have to upgrade our skills and effectiveness through excellence in education systems and better workplace training. Canada has a tremendous opportunity to enhance the quality of our education and skills, and to increase the number of Canadians working. To maintain labour force growth, we need a range of sources—addressing under-representation of certain groups in the workforce, removing disincentives to work and increasing immigration of skilled workers. Improved workforce adaptability and mobility will also be important.

Making progress in these areas means that more Canadians will have opportunities for better jobs and higher incomes. Also important will be the safety, creativity and sustainability of the communities within which Canadians live and the high quality of the social programs on which they rely.

RELATIONSHIP TO PROSPERITY

Better skills and higher education levels enable Canadians to secure better jobs and earn higher wages. This is fundamental to securing Canada's long-term prosperity. Similarly, to remain prosperous, our economy needs a workforce that is flexible and adaptable and people who embrace lifelong learning.

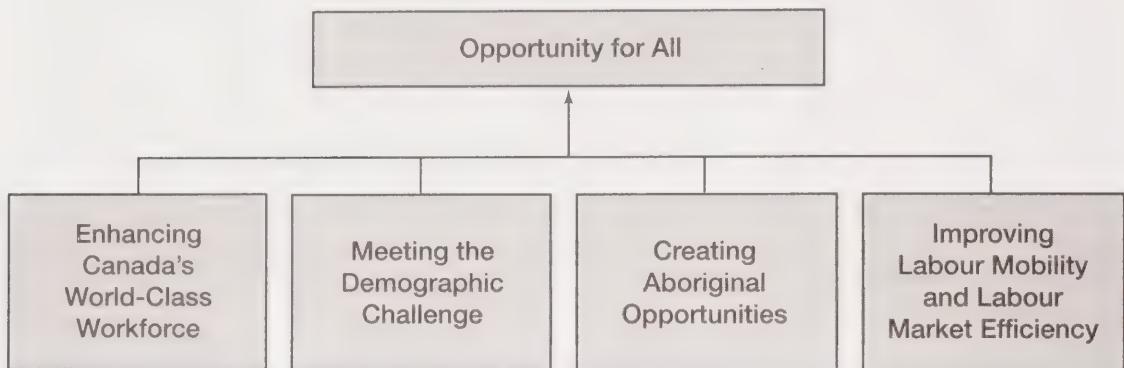
To meet these needs, our systems and institutions must:

- Build a world-class workforce by ensuring that all Canadians have the opportunity to acquire the skills and knowledge that they require to reach their full potential.
- Help address demographic challenges by eliminating barriers that have prevented some Canadians from participating fully in the workforce and attracting and retaining skilled individuals from around the world to complement Canadian talent.
- Create Aboriginal opportunities focusing on key priorities including health, housing, economic development and education.
- Improve labour mobility and labour market efficiency by supporting a workforce that is informed, adaptable and mobile so that Canadians can fully use the skills that they acquire.

In doing so, we will raise Canada's overall skill level, enhance our ability to harness new ideas and technologies and set in place essential conditions for sustained growth and rising standards of living.

Governments, educational institutions, business, labour and individuals all have important roles to play in ensuring that all Canadians have the opportunity to develop their skills and use their knowledge to their full potential. This is perhaps the single most important investment we can collectively make to promote economic growth.

Creating Opportunities for All Canadians



RECENT PERFORMANCE AND BROAD POLICY DIRECTIONS

1. Enhancing Canada's World-Class Workforce

In addition to bringing more people into Canada's labour force, we must constantly strive to improve the education and skill level of all Canadians. In other words, a world-class Canadian workforce must continually compete on quality. This means ensuring access and excellence throughout the education and skills continuum, starting with quality early learning and child care, and continuing through to post-secondary education and adult skills training and retraining.

Early Learning Is the Foundation for Quality

The foundation of a world-class workforce begins with early learning and child care that helps ensure children arrive at school ready to learn. This provides the basis for learning later in life and puts children on the path of lifelong achievement.

Federal Support for Early Learning and Child Care Is Significant

The Government of Canada makes significant investments in early learning and child care (ELCC) and early childhood development, in collaboration with provinces and territories. These national investments are embodied in the 2000 Early Childhood Development Agreement and the 2003 Multilateral Framework Agreement on ELCC. Together, these agreements will provide just over \$4 billion over the next five years in federal support to provinces and territories.

Building on these commitments, Budget 2005 provided a further \$5 billion over the same period in support of a new ELCC initiative in collaboration with provinces and territories.

In total, the Government of Canada is providing \$9 billion over the next five years to help enhance ELCC and early childhood development programs and services across Canada. Further investments will be made in collaboration with provinces and territories.

Canada benefits from effective primary and secondary school systems, with our youth ranking well in international comparisons, ahead of all but a few OECD countries. Young Canadians are already acquiring good levels of literacy in reading, math and science at primary and secondary schools, well above the OECD average and the U.S. Maintaining and building on this key advantage will make an important contribution to Canada's future competitiveness and prosperity.

The Government of Canada is committed to advancing and investing in literacy as an essential component to building a learning society. Since 1988 the federal National Literacy Secretariat has been working with provinces, territories and other partners to increase awareness and understanding of literacy issues and to ensure Canadians have opportunities to develop and improve the ever-expanding literacy skills needed to function at home, at work and in the community.

The basic skills of Canadian workers are improving, although more will be required. In the decade to 2004, the number of working-age Canadians (25-64 years old) who had not completed high school fell from 19 per cent to 11 per cent. While this significant progress is encouraging, high school non-completion remains an issue, because leaving school prematurely can result in a high personal cost (e.g. lower wages), as well as a significant social cost related to the loss of human potential. These costs are likely to become more significant as other countries increase the education level of their workforces.

Post-Secondary Education Is Essential

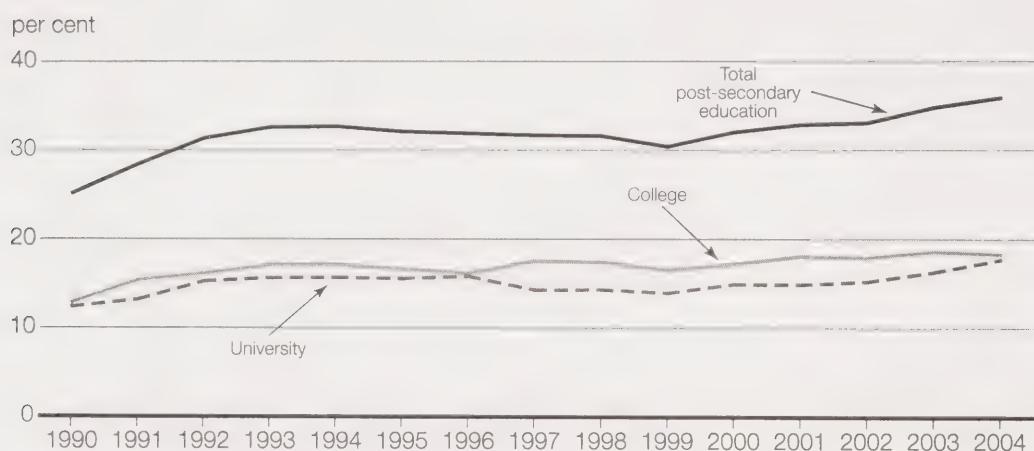
An affordable, accessible and quality post-secondary education system that is responsive to the needs of the labour market is essential to providing Canadians with the skills and adaptability required to be successful in today's rapidly changing economy. The majority of the new jobs created today require a post-secondary degree or diploma. Workers that possess the education and skills most in demand in the workplace are more likely to have and keep jobs.

A post-secondary degree or diploma also provides benefits to the individual that go beyond simply finding a job. People with post-secondary education have the opportunity to earn significantly higher wages. Individuals—working full time over a full year—with a bachelor's degree earn on average about 50 per cent more than high school graduates.

These benefits are recognized by Canadians, who know the personal and social value of post-secondary education. Today, more than 9 out of 10 youth surveyed aspire to post-secondary education. In fact, post-secondary enrolment in Canada is at an all-time high and is still growing. Canada should work to ensure that this trend in increasing enrolment continues.

More Young Canadians Are Attending College and University

Post-Secondary Education Enrolment in Canada
(18-21 Year Olds)



Source: Statistics Canada, Labour Force Survey.

Barriers to Post-Secondary Access Must Be Minimized

All Canadians, no matter what their background, must have the opportunity to pursue post-secondary education. Minimizing barriers to post-secondary access is a critical part of improving educational outcomes and creating opportunities for all Canadians.

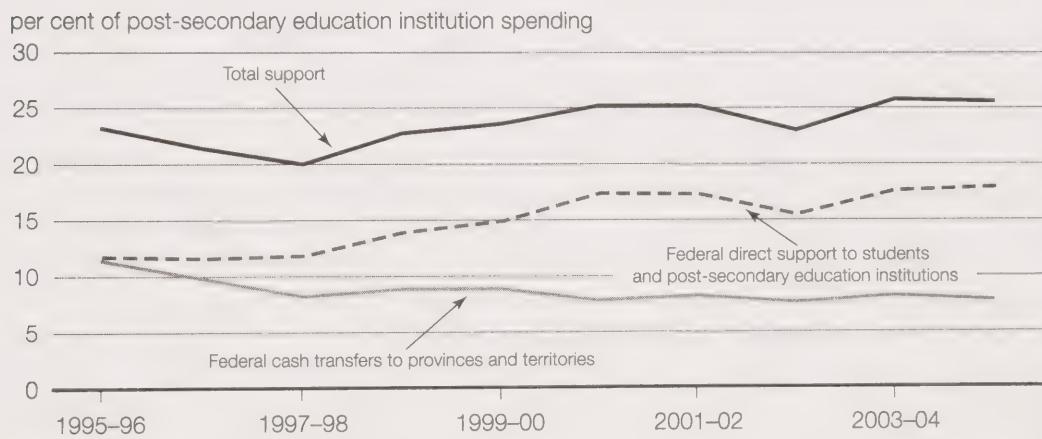
Numerous studies show that the decision to pursue post-secondary education is influenced by a number of interrelated factors such as parents' education levels, secondary school performance, living in an urban or rural area and interest and motivation. The combined impact of these factors may be particularly acute for certain segments of the population whose participation rates (particularly for university) are below the Canadian average—including individuals from low-income families, persons with disabilities and individuals from rural areas.

Although not the primary determinant of participation in post-secondary education, family income remains the most common lens through which participation rates are often viewed. Financial barriers to post-secondary education are declining due to improvements in student financial assistance (e.g. the Canadian Opportunities Strategy, recent increases in Canada Student Loan limits, the introduction of the Canada Access Grant for first-year students from low-income families, and improvements in debt management measures for students facing exceptional financial difficulty in repaying their student debt). It is important that Canada remains vigilant to ensure that barriers to participation in post-secondary education are minimized.

Federal Support for Post-Secondary Education Is Significant

Government of Canada support for post-secondary education amounts to close to \$9 billion each year, including an estimated \$3.8 billion in both cash and tax points through the Canada Social Transfer, and \$5 billion in direct spending and tax expenditures. Total federal cash transfers and direct Federal support (\$7 billion) have remained relatively constant at approximately 25 per cent of overall support for the post-secondary sector. In recent years, federal spending on post-secondary education has been increasingly focused on access and research excellence.

Federal Support for Post-Secondary Education Is Relatively Constant



Source: Department of Finance Canada calculations.

Direct support helps students and families save for future education via the tax system, as well as promote access to post-secondary education through grants, scholarships and loan programs. The tax system also helps offset the costs of post-secondary education. In addition, the Government of Canada provides significant funding for research and innovation through granting councils, research chairs and other measures in support of the growth agenda (see Chapter 5).

The Government of Canada recognizes the importance of achieving excellence in post-secondary education, and remains committed to working with provincial and territorial governments, as well as universities, colleges, educators and students, to ensure a dynamic and accessible post-secondary education system.

Canadians Have High Post-Secondary Attainment Rates

Canadians are among the most highly educated people in the world. In 2002, 43 per cent of our population aged 25-64 had some post-secondary education—the highest percentage of all OECD countries. For younger Canadians, the story is even better: for those aged 25-34, this proportion increases to 51 per cent—again the highest level in the OECD.

Differences emerge, however, when looking at college and university attainment rates individually. Canada is well ahead of the United States with respect to college level attainment (for those aged 25-64) but not as successful when it comes to university attainment, where the U.S. surpasses Canada.

Several countries, including the United Kingdom, the United States and Australia, are striving to make improvements to their post-secondary education systems in order to position themselves for future global competition. Canada must continue to strive for excellence in post-secondary education, both to produce the calibre of graduates best suited to the global labour market, and to ensure that Canada can attract the best and brightest students, professors and researchers to our colleges and universities.

Building the Foundation for an Innovative Economy: The Role of Higher Education

A nation's innovative capacity is a critical determinant of its economic growth. Canada's future ability to innovate depends not only on the number of post-secondary graduates, but also on their field of study, their educational environment, the extent of their international experience and the level that they reach.

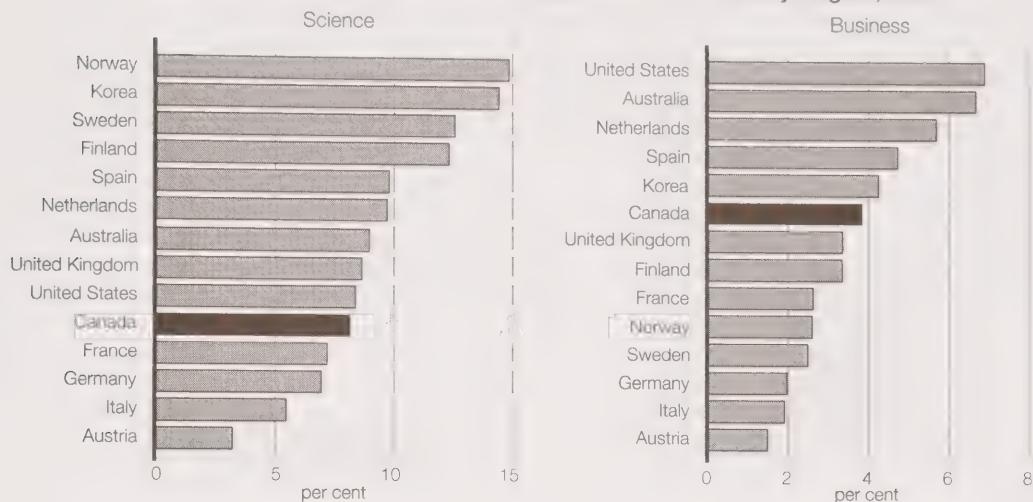
Workers with advanced degrees in science, engineering and mathematics increase the capacity of firms to conduct and invest in research and development and to successfully adopt new technologies. As well, professionally trained managers foster the creation of new businesses and secure the commercialization of new products and innovative technologies. Individuals with both strong science and business backgrounds often act as the key links between the research laboratory and the marketplace, and facilitate the transfer of knowledge needed to translate research leadership into economic success. Canada can do more to foster the development of workers with both science and business expertise.

On these measures, Canada's performance is weaker than it should be. When looking at the proportion of youth with a university degree in science, Canada lags only slightly behind the U.S., which itself ranks in the middle among OECD countries. However, when it comes to the proportion of youth with a university degree in business, Canada lags far behind the United States, which is at the top of the OECD rankings.

It is important to have a sufficient number of people pursuing graduate education, as these students are the most likely to be at the forefront of the latest technological breakthroughs. However, relatively fewer Canadian undergraduates pursue graduate studies. In spite of increases in post-secondary enrolment, Canada still has a lower proportion of its population—by almost one-half—with a master's or Ph.D. degree than does the U.S. Although it is difficult to compare higher education qualifications across countries, OECD data on qualifications from advanced research programs—which generally correspond to doctorates—suggest that Canada has only an average performance on the training of doctorates, lagging the United States and many other countries.

Canada Trains Fewer Scientists and Managers

Percentage of the 25-34 Year Old Population With a University Degree, 2003



Source: OECD, *Education at a Glance* (2005). Science includes life sciences, physical sciences, mathematics and statistics, computing, engineering, agriculture and health.

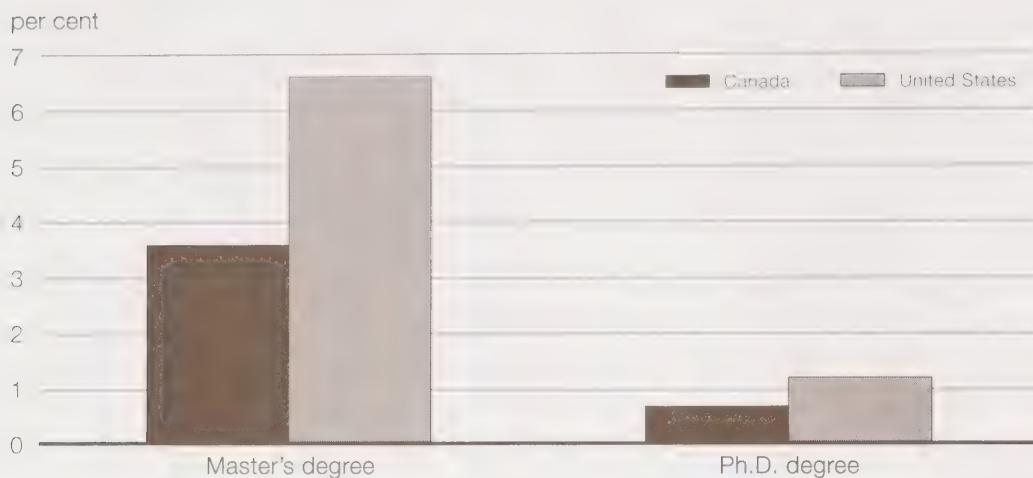
Advanced studies at the graduate and Ph.D. levels provide students with research experience, which is the skill set that technology-intensive firms need to support their technology development and adoption activities. Fewer people in Canada with graduate degrees means, for example, fewer replacements for aging professors, research and development workers and professionally trained managers. In a global, knowledge-based economy, these shortfalls may take on increasing importance, especially with emerging economies like India and China graduating significant numbers of students with advanced degrees (engineering in particular).

In order to benefit fully from an increased supply of well-educated workers, particularly at the graduate level and in the fields of science, engineering, mathematics and business, Canada must ensure that individuals have the opportunity to apply their skills in a business environment that fosters innovation and growth.

Finally, the quality of the environment in which students learn is also important. Facilities that are already or are at risk of becoming crowded, poorly maintained or out-of-date hurt the overall quality of education offered. This diminishes the ability of the post-secondary system to attract students and produce graduates that are qualified to use the most technologically advanced equipment and impedes capacity to perform top-calibre research. It is important to ensure that university and college capacity keeps up with growing enrolments and students' learning and training needs.

Canada Has Fewer People With Graduate Degrees

Percentage of the 25-64 Year Old Population With a Graduate Degree, 2001



Sources: Canadian data from Census; U.S. data from March Current Population Survey.

The Government's Investments Have Created a World-Class University Research Environment

"The federal government has invested substantially in knowledge creation since 1997 through increased funding to the federal research granting agencies and by establishing several key programs such as the Canada Foundation for Innovation, the Canada Research Chairs, a permanent program to fund the indirect costs of research, and increased financial support to graduate students. This has been a bold and coherent strategy.

It would be hard to overstate the impact that these programs have had on Canada's universities. There's a new vitality on our campuses, and a growing recognition globally that Canada is a major player in research."

Momentum—The 2005 Report on University Research and Knowledge Transfer
Association of Universities and Colleges of Canada

Skilled Workers Are Also Needed

Workers in the skilled trades are important contributors to Canadian prosperity. These workers need a strong educational base and regular upgrading of their skills to keep up with change and competition. Colleges and apprenticeship programs are critical providers of this training. Labour and business must play a role. All stakeholders must work together effectively to support the acquisition of literacy and essential skills, apprenticeships and skills upgrading in the workplace.

Technological change is altering the skills and work environment for skilled trades. These impacts vary from “deskilling” (e.g. the introduction of pre-fabricated materials on job sites) to skill enhancing (e.g. new computer-based technologies) and vary across occupations and trades. Many trades are targeting higher levels of certification and training in their members.

A world-class workforce is adaptable and committed to lifelong learning that does not end after completion of formal education. Today, workers are frequently called upon to adapt to new technology and work processes throughout the course of their careers. Providing access to learning and skills upgrading opportunities to achieve this adaptation will be important. This is particularly true for members of the current workforce who do not have a post-secondary degree or diploma and who, without such opportunities, may be at risk of being left behind.

In spite of high rates of post-secondary education overall, there is still a relatively large pool of workers with low skill levels. Over 40 per cent of adult Canadians do not meet the minimum literacy standard deemed necessary to function and succeed in the knowledge-based economy.

Cooperative education programs enable students to gain an understanding of the kinds of skills needed in the workplace. Creating opportunities for more students to gain private sector experience would better prepare young Canadians for the workplace.

An increasing emphasis on improved literacy and lifelong learning requires more training and greater investments by employers. Yet Canada currently has a lower rate of workplace training investment by firms and individuals than some competing countries. The 2003 *OECD Employment Outlook* reports that 31 per cent of Canadian workers participated in employer-sponsored training, compared to 35 per cent for the United States and 45 per cent for the United Kingdom. Between 1997 and 2002, the rate of participation in employer-supported training increased only marginally.

For workers in small enterprises and with low skill levels, the current training investment trends mean poor access to formal training—leading to an increased skill and income polarization. This can be exacerbated by literacy problems. To illustrate, in OECD countries employees with trade certificates are half as likely, and employees with less than a high school diploma are five times less likely, to receive employer-sponsored training as those with a university degree. Furthermore, employees in small and medium-sized enterprises are only half as likely to receive formal training as those in large enterprises.

In sum, underinvestment and low participation in workplace training need to be addressed. Canadian workers must be supported by a culture of lifelong learning and stronger commitments by employers to enhanced workplace-based skills development.

BROAD POLICY DIRECTIONS**Enhancing Canada's World-Class Workforce**

- ✓ The Government will, in partnership with provinces and territories, continue to minimize barriers to access and, in the future, ensure that student financial assistance programs consistently meet the needs of students, for example, by extending first-year grants to students for all years of undergraduate studies.
- ✓ The Government will work to increase opportunities for students to study abroad.
- ✓ The Government will encourage Canadians to pursue graduate studies opportunities, especially in sciences and management.
- ✓ The Government will contribute to ensuring the capacity to provide high-quality post-secondary education.
- ✓ The Government will continue to promote a culture of lifelong learning and skills upgrading by working with business, labour and provincial partners to enhance workplace-based skills development—including essential skills and apprenticeship. In addition, the Government will work with provinces on the development of a comprehensive national literacy strategy.

2. Meeting the Demographic Challenge

As discussed in Chapter 3, Canada's aging population is expected to result in a decrease in the share of our population that is in the workforce. The projected decline in the number of people working will gradually reduce Canada's ability to continue to improve living standards. This can be mitigated in part by increases in the productivity of Canadians and greater workforce participation.

Under-Represented Groups Must Be Included

Improving the inclusiveness of Canada's labour market can help to offset the declining rate of growth in the workforce as the population ages. This goal could be achieved through increased workforce participation by a number of groups in Canada, including older workers, persons with disabilities, recent immigrants and low-income Canadians. All of these groups continue to have lower employment rates than the overall Canadian population. As noted in Chapter 3, raising the employment rate of these groups would increase Canada's GDP per capita.

Participation in the Workforce Remains a Challenge for a Number of Groups



Sources: Population (15-64) and older workers (55-64) data from Statistics Canada, Labour Force Survey (2004); Aboriginal Canadians and recent immigrants data from Statistics Canada, Census 2001; persons with disabilities data from Statistics Canada, Participation and Activity Limitation Survey (2001).

Older Canadians

Older Canadians who wish to remain in the workforce represent an important resource. Canada lags behind a number of countries, including the U.S., in terms of the employment rate of those aged 55-64.

It is important that older Canadians who want to work are not faced with institutional and financial disincentives to doing so. One challenge in this regard is to ensure the capacity of older workers to retain employment and earning levels—they may need employment assistance services. Moreover, firms could be encouraged to provide workplace training for, and employment opportunities to, older workers. We also need to consider providing more mentorship and knowledge-transfer opportunities between older and younger workers.

The public pension system in Canada ranks among the best in the world in providing basic retirement income for seniors, while remaining affordable and sustainable. Still, our retirement income system must be able to adequately accommodate a growing variety of job types and retirement transitions. This would help to raise the level of workforce participation of older workers, while ensuring Canadians continue to have adequate income in retirement. The legislated review of the Canada Pension Plan with provincial co-stewards every three years provides such an opportunity.

Persons With Disabilities

Educational and employment outcomes for persons with disabilities are lower than those of Canadians without disabilities. For example, young persons (aged 15-24) with disabilities are less likely to attend school than those of the same age without disabilities (52 per cent versus 68 per cent). Adults with disabilities are also over three times more likely to be out of the labour force than adults without disabilities.

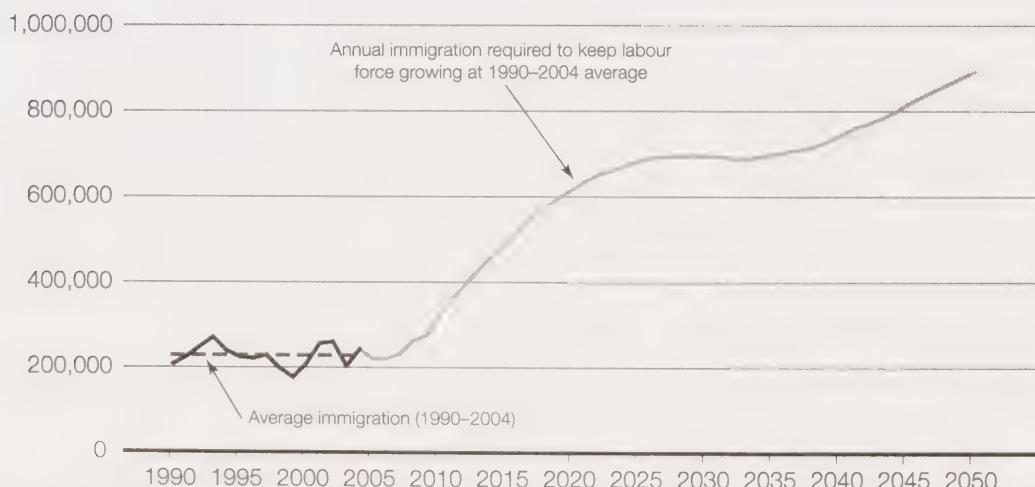
Efforts must continue to be made to improve the inclusiveness of Canada's workforce by removing barriers to post-secondary education, specialized training and to workforce participation for persons with disabilities who wish to enter or remain in the workforce.

Immigrants

Immigration not only enriches Canada's diversity, it also bolsters our labour force and our prosperity. Immigration is an important source of labour force growth and is expected to account for all of the net growth in Canada's population within the next 10 years, if current trends continue. All other things being equal, to maintain the annual labour force growth rate observed between 1990 and 2004 (1.4 per cent) through to 2050, assuming constant birth rates, annual immigration levels would have to more than quadruple by then, rising to almost 900,000 annually.

Canada's openness to immigration provides an important competitive advantage. More than 50 per cent of recent immigrants have some post-secondary education or trades certification. Incoming immigrants are, on average, more highly educated than the Canadian-born population, raising Canada's overall education attainment level.

Immigration Would Have to Quadruple by 2050 in Order to Maintain Labour Force Growth at 1990–2004 Average



Sources: Department of Finance Canada calculations. Underlying labour market projections to 2010 based on the Department of Finance September survey of private sector forecasters. Underlying population projections based on the Office of the Chief Actuary's (OCA) National Population Projections (May 2005). Immigration levels to 2004 based on Statistics Canada estimates. Immigration levels in 2005 based on OCA projections.

Increasing the number of skilled and educated immigrants—coupled with improved labour market integration policies and practices—would ensure continuing growth in the labour force, help minimize localized labour shortages and facilitate labour market adjustments in years to come. Higher employment rates for immigrants would also help mitigate the expected decline in the share of Canada's population in the workforce and, consequently, contribute positively to Canada's living standards.

The challenge lies in ensuring that the immigration system can meet the needs of the economy and helps fill gaps, and that this inflow of new, skilled, talented individuals can easily integrate into the workforce and the community. In this regard, provinces and professional regulatory bodies have crucial roles to play. Many immigrants have difficulty continuing in the professions and careers in which they were engaged in their country of origin. For example, immigrants who arrived in Canada in the first half of the 1990s have experienced lower earnings and poorer labour market outcomes relative to native-born Canadians with similar levels of education and skills.

Recent increased investments in settlement programs, advanced language training for work, and efforts to ease the recognition of the credentials of newcomers to Canada will speed the integration of immigrants into the workforce. This will enable them to more fully use their skills in Canada.

Thus, while Canada is working from a good base, our immigration system needs to be examined for gaps to see how we can do even better. Before increasing overall levels of immigration, we must ensure that the immigration system operates in an efficient and effective way in meeting Canadian objectives. Our immigration strategy must be a balance between increasing the number of immigrants coming to Canada to meet Canada's evolving labour force needs, and having immigrant integration policies and practices that ensure their full participation in the workforce and the community.

Low-Income Canadians

Participation in the workforce is a challenge for many low- and modest-income Canadians. Social assistance recipients, in particular, face significant financial barriers to paid employment: moving into the workforce often means facing a series of obstacles that may make them financially worse off. All orders of government must work together to find ways to reduce the barriers that have prevented many low-income Canadians from participating fully in the workforce, help them achieve self-sufficiency and contribute to higher standards of living for everyone in the long run (see Chapter 7 for additional information).

In sum, strategies to expand our workforce and make it more inclusive are needed to help secure our collective future prosperity. However, numbers are not everything. In fact, raising employment rates of under-represented groups to the national average will only close a small part of our income gap with the U.S. (as discussed in Chapter 3). And more than quadrupling the immigration levels will just maintain the current rate of labour force growth. Moreover, measures that increase the quantity of Canadian workers must be set against the realities and pressures brought about by the global competition for talent.

BROAD POLICY DIRECTIONS
Meeting the Demographic Challenge

- ✓ The Government will work with partners to increase the workforce participation of currently under-represented groups—such as older Canadians and persons with disabilities—by reducing barriers to participation in the workforce and improving work incentives.
- ✓ The Government will work to improve the efficiency and effectiveness of our immigration system and then increase immigration of skilled and educated workers.
- ✓ The Government will continue to improve immigrant integration, working with provinces and territories.
- ✓ The Government will partner with provinces, businesses, labour and professional associations to better match immigrants with skill requirements, broaden the regional distribution of immigrants and improve foreign credential recognition.
- ✓ As outlined in Chapter 7, the Government will consult with provinces and territories to design and introduce a Working Income Tax Benefit to make work pay for low-income Canadians.

3. Creating Aboriginal Opportunities

Currently, there is a greater percentage of Aboriginal youth under the age of 25 than in the rest of the Canadian population. These youth are poised to enter the labour market, enter post-secondary education or move on to advanced skills training in the next three to five years. However, Aboriginal Canadians continue to face a number of barriers to successful labour market participation. In 2001, 5.3 per cent of young Aboriginal Canadians (aged 15-24) had a university degree or college diploma, as compared to 15.7 per cent of all Canadians of the same age group. On reserve, only about 2.5 per cent of the young Aboriginal population had a university degree or college diploma.

Many Aboriginal Canadians also face poor employment prospects, especially if they live in communities where there are limited economic opportunities. For Aboriginal Canadians who have a post-secondary degree or diploma and who live off reserve, the employment rate is virtually the same as that for non-Aboriginal Canadians.

Although gaps are closing, significant improvements in Aboriginal Canadians' participation in higher education, and readiness for the labour market, would help them participate fully in the economy.

BROAD POLICY DIRECTIONS
Creating Aboriginal Opportunities

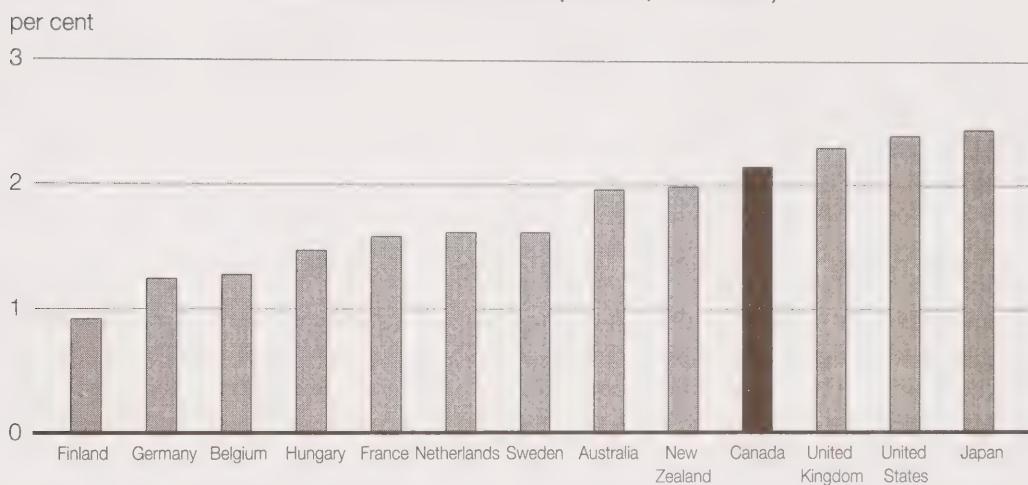
- ✓ Agree on transformative approaches to health, housing, economic development and education at the upcoming First Ministers' Meeting with Aboriginal leaders.

4. Improving Labour Mobility and Labour Market Efficiency

Canadians invest a lot in their education, so it is important to ensure that they can easily find, and relocate to, where their education and skills are in demand. Canada enjoys a fairly mobile population and labour force, a key factor in adapting quickly and efficiently to changes in the structure of the economy. With the profound changes in the global economy currently underway, this flexibility may become increasingly important.

Mobility of Canadians Remains Relatively High

Internal Migration
(Ratio of Gross Flows to Population, Mid-1990s)



Source: OECD, *Economic Outlook*.

Initiatives, such as the 1996 employment insurance reform, and efforts under the Agreement on Internal Trade to remove inter-provincial barriers to labour mobility, have increased labour mobility. Nonetheless, regional unemployment rates continue to vary more across provinces than across U.S. regions, suggesting that labour mobility remains an issue for some provinces more than others. Provinces hold some of the keys to increasing labour mobility, including improved credential recognition and reduced barriers to internal trade.

While the Government of Canada is working with the provinces to improve labour mobility across the country, it is also investing through national programs and the regional development agencies to improve employment opportunities in each region. Priority areas for regional agency action include supporting research and technology infrastructure, helping firms become more innovative, building local capacity to deal with adjustment challenges, and diversifying the range of economic activity.

Mobility within a nation's borders is important, but so too is international mobility and experience. In the past, the most highly skilled workers moved to advanced economies to employ their skills. The globalization of production has increased opportunities for these workers to apply their skills in their home country. At the same time, labour mobility between advanced economies has also increased. All of this results in more intense competition for talent. Workers with experience outside of Canada can bring home new skills, knowledge and practices, as well as networks of international contacts, all of which are important contributions to Canada's competitive advantage.

Labour Market Information Can Influence Decisions

Timely, accurate and relevant labour market information helps students and workers make well-informed decisions about educational paths, careers and jobs. It also influences decisions regarding business investment. Canada has good aggregate labour market information, but is less successful in getting this information to individuals, firms and educational institutions. Labour market information at the regional level could be improved. Enhanced labour market information would help better address supply and demand imbalances in some areas of the labour market where there are workers without jobs, or jobs without workers.

The Employment Insurance Program Plays an Important Role

The Employment Insurance (EI) Program is the primary labour market program in Canada. It provides income replacement in the event of a job loss, and is designed to allow workers the time to find a job that is a good match to their skills and abilities. EI active employment measures, such as skills training, are designed to enhance the ability of Canadians to prepare for, obtain and maintain employment. It is therefore important to ensure that EI, on an ongoing basis, meets the changing needs of Canadians in the workforce; remains in line with evolving labour market needs; and maximizes the potential contribution of the program to the mobility, flexibility and adaptability of the labour force.

BROAD POLICY DIRECTIONS

Improving Labour Mobility and Labour Market Efficiency

- ✓ The Government commits to working with provinces, territories and stakeholders to reduce barriers to labour mobility across the country.
- ✓ The Government will work to minimize impediments to labour market efficiency by improving the quality and timeliness of labour market information.
- ✓ The Government will ensure that the EI Program, on an ongoing basis, effectively meets the changing needs of the workforce and the economy.

Advancing an Innovative Economy

OVERVIEW

Technological change continues to transform the global economy. As advances in broadband communications diffuse information more quickly, basic technologies commoditize and the premium on innovation increases. Global labour markets are emerging, changing the returns to skilled work and the location of skilled workers.

Innovation contributes to economic growth by increasing efficiency and creating new products. Innovative firms create jobs and ultimately provide higher wages. Countries at the forefront of innovation will be best placed to develop the high value-added sectors that can provide new sources of growth.

No single element on its own creates an innovative economy. The innovation system is made up of complex and complementary activities of public institutions, workers and firms.

As a result, improving Canada's innovation performance demands a multi-pronged strategy. Most fundamentally, improvement in Canada's innovation performance will be underpinned by a strong environment for investment, a competitive tax system, promotion of domestic competition and openness to foreign direct investment. These are discussed in Chapters 6 and 7.

These fundamentals need to be complemented with a strong foundation in primary research resulting in new discoveries, and training for highly sophisticated researchers essential for the knowledge and resource economies. In order to attract, cultivate and retain the best and the brightest, Canada must be at the heart of international research networks. The Government has a critical role to play in stimulating improved private sector commercialization and R&D performance, tackling the market failures that slow the diffusion of new ideas, and facilitating partnerships between researchers and industry to turn invention into innovation and concept into product.

RELATIONSHIP TO PROSPERITY

An innovative economy rests on the foundations of knowledge created in its universities, the level of excellence it attains in discovery, and its success in training people with advanced skills. Innovation is fuelled by new technologies adopted by firms through their investments in machinery and equipment and the ideas they develop through firm-based proprietary R&D and technology licensed from abroad. By training more highly qualified people and raising investments in new technologies and R&D, an economy raises its productivity, rate of economic growth and standard of living.

University Research Creates New Ideas and Highly Skilled Innovators

By far the most important contribution made by research-intensive universities is in training highly skilled graduates that businesses increasingly need to develop and adopt new technologies. Through their university experience, students gain exposure to leading-edge research concepts and techniques. Recent graduates transfer the knowledge generated from university research to the companies that hire them. Getting the brightest students and university researchers to interact with knowledge-intensive firms exposes students to private sector challenges and creates linkages for future collaboration.

University research, of course, also creates a better understanding of the world around us, strengthens public policies, enriches our culture, leads to new health care practices and medicines, and adds to the general stock of ideas that companies can apply to create value.

As the discoveries that come from primary research are widely available, the benefits are not confined to a single user but “spill over” to companies across the economy. The OECD estimates that the economy-wide spillovers from public research have a 40 per cent greater impact than the more limited (but still important) spillovers from private sector research.¹ Canada also greatly benefits from public research performed abroad. The better networked we are to international research, the more we will benefit.

Investment in Machinery and Equipment Transfers New Technologies

Investment in machinery and equipment gives firms access to the latest ideas embedded in leading-edge technology. New technologies enable workers to produce more and higher-quality goods and services through more efficient business processes. In turn, this can reduce production and operating costs for companies and contribute to faster growth.

There is growing evidence that investment in information and communications technologies (ICT) played a crucial role in accelerating productivity growth in the latter half of the 1990s. This ICT-related productivity growth acceleration occurred only in a few countries, including Canada, Australia and the U.S. The OECD estimates that two-thirds of Canada’s productivity gains over the period 1990–2000 were attributable to industries that use ICT intensively, and to ICT producers. The digitization of information, common computing standards and the Internet are also enabling the creation of international supply and production chains, in which investment and work are moving to the most productive locations. This is expected to continue.

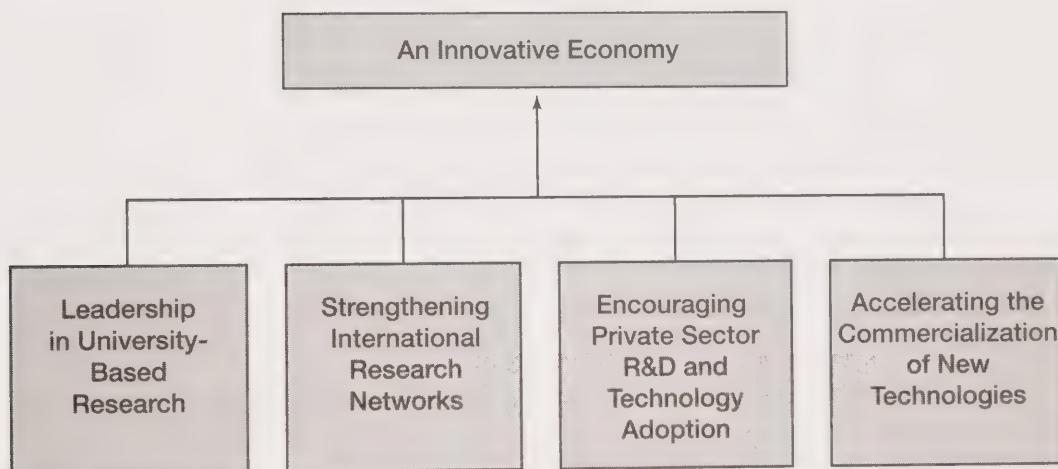
¹ Dominique Guellec and Bruno van Pottelsberghe de la Potterie, “R&D and Productivity Growth: Panel Data Analysis of 16 OECD Countries,” *OECD Economic Studies*, No. 33 (2001).

Private Sector R&D Generates Wealth

Research activities in the public and private sectors are complements. Businesses cannot make full use of the knowledge generated by universities and other public labs unless they have their own research capacity. A company's capacity to undertake R&D also increases its ability to apply developments from private sector R&D undertaken by others to improve its own products and processes and to understand and adopt new machinery and equipment.

Private sector R&D is critical because it is more directly correlated to economic growth than public research. The OECD estimates that a 1-percentage-point increase in the research undertaken by the private sector as a proportion of GDP could increase the average level of GDP per capita by as much as 12 per cent in the long run.²

Advancing an Innovative Economy



² OECD, *The Sources of Economic Growth in OECD Countries* (2003).

RECENT PERFORMANCE AND BROAD POLICY DIRECTIONS

Canada's leadership in public research creates a strong foundation for building a more innovative economy. Improving the linkages between Canadian universities and firms will enable the private sector to take better advantage of university-based discoveries. Canadian firms are adopting leading-edge technology through investments in machinery and equipment and R&D. While Canadian firms are already reasonably innovative by international standards, they have the opportunity to increase value they realize from their innovations in the marketplace.

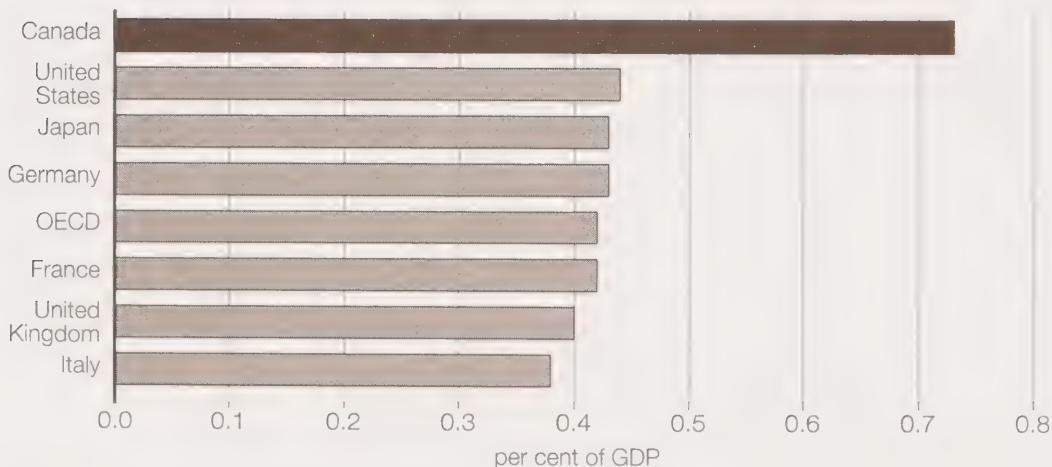
1. Leadership in University-Based Research

To fuel their innovation, companies often rely on new ideas from university research and graduates educated at the frontiers of knowledge. Canada is creating a world-class university research environment through investments in people, research and world-leading equipment and facilities.

The Government has focused its investments at the earliest stages of the innovation process, where the private sector tends to underinvest. In no small part due to these investments, Canada is now far and away the G7 leader in terms of university R&D performance as a share of GDP, and second in the OECD behind Sweden. Since 1997, the Government has invested a cumulative \$12 billion in new funding to strengthen support for researchers, facilities and equipment and the research environment at universities. Increased contributions from the universities themselves, provincial governments and the private sector complemented this strengthening of the R&D capacity of our universities.

Canada Leads G7 in Performance of University R&D

Higher-Education R&D as a Share of GDP



Source: OECD, *Main Science and Technology Indicators* (May 2005).

These investments are having an impact: academic publications by Canadian university researchers increased by 30 per cent between 1997 and 2004, double the increase experienced over the previous seven-year period. As well, the Government's investments have helped universities to retain and attract leading researchers, reversing the "brain drain" of scientists to other countries and making Canada a preferred location for in-demand researchers. There are 3,200 more researchers at Canadian universities now than there were five years ago.

Universities have also used the new resources to develop high-quality graduate programs with growing international reputations, which are key to training new researchers and attracting high-calibre students from elsewhere.

Canadian Universities Are Now Attracting Leading Researchers

Michael Byers

University of British Columbia

Dr. Byers was previously Professor of Law and Director of Canadian Studies at Duke University and is well-known for his work in international law and politics.

Jillian Buriak

University of Alberta and National Institute for Nanotechnology, Edmonton

Winner of the 2003 American Chemical Society Award for Pure Chemistry, Dr. Buriak is a specialist in silicon surface chemistry and comes to Canada from Purdue University.

Bill Thomlinson

Executive Director, Canadian Light Source Inc., Saskatoon

Dr. Thomlinson held a number of research and senior management positions with Brookhaven National Laboratory in the U.S. and was Head of the Medical Research Group at the European Synchrotron Radiation Facility in Grenoble, France, before moving to Saskatchewan to lead Canada's synchrotron.

Jacques Corbeil

Université Laval

Dr. Corbeil comes to Laval from the University of California, San Diego, where he was Director of the Genomics Core Laboratory and focused on infectious diseases and certain cancers.

Jeremy M. Grimshaw

Ottawa Health Research Institute and University of Ottawa

Dr. Grimshaw, a knowledge translation expert, previously held a number of positions in the United Kingdom, most recently in Health Services Research at the University of Aberdeen.

Hélène Paradis

Memorial University of Newfoundland

A specialist in childhood cancers, Dr. Paradis held a postdoctoral fellowship at Harvard's Dana-Farber Cancer Institute, and worked on the faculty of the University of Cincinnati before joining Memorial University.

BROAD POLICY DIRECTIONS
Leadership in University-Based Research

- ✓ The Government commits to maintain Canada's G7 leadership in university-based research.
- ✓ Over coming years the Government will make major ongoing investments to build world-leading equipment and facilities, attract the best researchers and support primary research.
- ✓ The Government will continue to improve its monitoring of investments and strengthen reporting on research outcomes.

2. Strengthening International Research Networks

The creation of research-intensive universities that meet international standards of excellence provides a foundation for collaborating with the best institutions abroad and attracting leading students and researchers from other countries.

Canada benefits from accessing the discoveries that result from other countries' investments in primary research. Canada's total national investment in university R&D in 2003 was about US\$6.7 billion; Germany invested US\$9.6 billion, Japan US\$15.0 billion and the United States US\$47.7 billion. Strengthening the networks between our leading universities and institutions in these countries opens up channels to transfer knowledge from a much larger research base.

While we have about 35,000 university researchers in Canada, Germany has more than 70,000, Japan more than 170,000 and the U.S. over 185,000. Emerging economies such as India and China are also significantly expanding their training of highly skilled workers—there are now over 1 million R&D personnel in China alone. The best and brightest from around the world are attracted to institutions with world-leading facilities, and which are performing research that meets the highest standards of international excellence.

Our international leadership also means managing the global commons essential to our shared prosperity and promoting research in areas which address the priorities of least developed countries such as health and environmental technologies.

BROAD POLICY DIRECTIONS
Strengthening International Research Networks

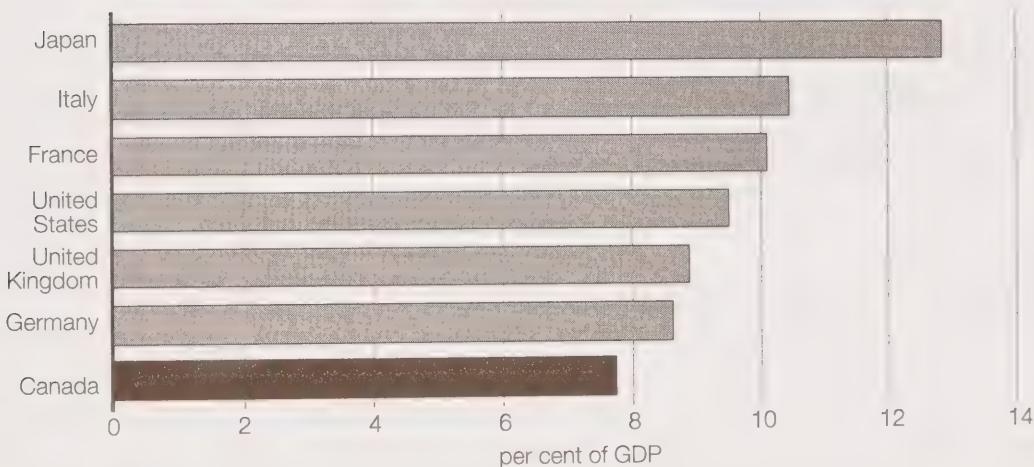
- ✓ The Government will strengthen its support for universities and researchers to develop international networks and participate in research partnerships that improve Canada's access to leading-edge research.
- ✓ The Government will make it easier for the best and the brightest researchers from around the world to work in Canada.
- ✓ Fulfill our commitment to devote 5 per cent of federal R&D to problems faced by the developing world, including in areas such as health and environmental technologies.

3. Encouraging Private Sector R&D and Technology Adoption

Canadian firms appear to underinvest in technology adoption and R&D. Business investment in machinery and equipment is one measure of the rate of technology adoption in an economy. By this measure, Canadian firms invest less than their peers in other major countries, a pattern that has persisted for at least three decades. However, potentially as a response to the improved investment environment described in Chapter 7, it is encouraging that total investment in machinery and equipment has increased in Canada as a share of our economy over the past 10 years. Much of the machinery and equipment that is purchased by Canadian firms is sourced from outside the country, giving our companies access to foreign R&D.

Canadian Firms Could Benefit From Greater Investment in Machinery and Equipment

Average Investment in Machinery and Equipment as a Percentage of GDP, 1993–2003



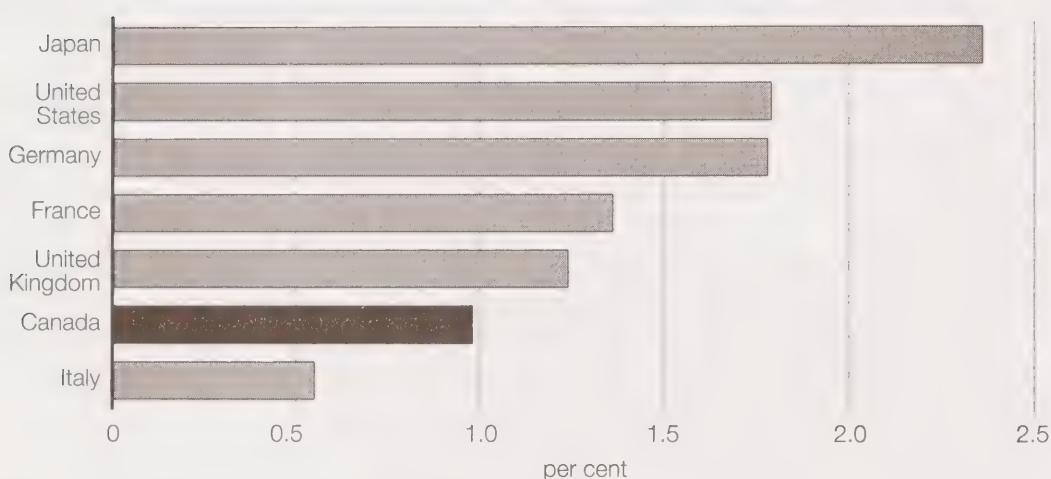
Sources: OECD, Annual National Accounts; Statistics Canada; Bureau of Economic Analysis.

Higher R&D Investments Create Opportunity for More Rapid Growth

Overall, Canadian private sector R&D investments are lower as a share of our economy than in most other advanced countries. Canada ranks sixth in the G7 in terms of private sector R&D investments as a share of GDP. Canada's business expenditures on R&D to GDP ratio was less than 1.0 per cent in 2004, compared to 1.8 per cent for the U.S.

Total Canadian R&D Investments Have Room to Grow

Private Sector R&D as a Percentage of Industry Value Added, 2004



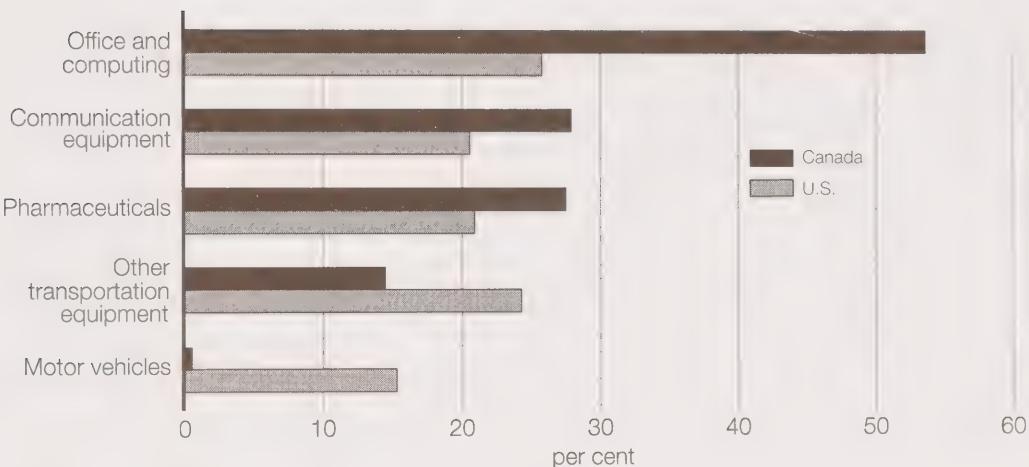
Source: OECD, *Main Science and Technology Indicators* (May 2005).

Most of the Canada-U.S. gap results from differences in the structure of Canada's economy. About two-thirds of the gap results from lower R&D investment levels in the automotive and service sectors. Canada's automotive sector devotes less than 5 per cent of its value added to R&D, compared to over 15 per cent in the U.S. However, Canadian-based assemblers benefit from their parent companies' R&D investments as new machinery and manufacturing processes are transferred to facilities in Canada. Although the R&D intensity of the Canadian service sector remains lower than in the U.S., Canadian service sector firms increased their investment in R&D threefold from 1991 to 2002. The improved policy environment since 1994 likely encouraged the closing of this gap; but more remains to be done.

Overall, Canada's high-technology sectors have a strong R&D record. Among OECD economies, the most R&D-intensive sectors are office and computing products, communication equipment, pharmaceuticals, other transportation equipment (primarily aircraft) and motor vehicles. Canadian companies in the first three of these sectors invest, as a percentage of value added, as much or more than their competitors. However, as these sectors are a smaller part of Canada's economy compared to the U.S., this limits their impact on national R&D data.

Canadian Firms in Most Leading High-Tech Sectors Are More R&D-Intensive Than U.S. Firms

R&D as a Percentage of an Industry's Value Added, 1999



Source: Aled ab Iorwerth, "Canada's Low Business R&D Intensity: The Role of Industry Composition," Department of Finance Canada Working Paper (2005).

Higher rates of growth in the R&D-intensive sectors, and continued increases in R&D by the service sector, will raise Canada's overall R&D intensity over time. Higher investments in research and technology development and adoption support economic growth and can also contribute to a more sustainable economy. The Government's increased investments in environmental technologies are helping Canada better achieve both objectives.

Building an Innovative Environmental Technology Sector

Investments in environmental technology have the dual advantage of promoting economic growth and improving the environment through stronger environmental performance and reductions in greenhouse gases (GHGs) by, for example, promoting increased energy efficiency and alternative energy sources. The Government of Canada has made significant investments to promote the research, development and adoption by the private sector of innovative technology solutions to our environmental challenges. These investments include:

- The Climate Change Technology and Innovation Initiative, which invests in five strategic technology areas: cleaner fossil fuels, the hydrogen economy, advanced end-use efficiency technology, decentralized energy and biofuels. By working in partnership with the provinces, the private sector and universities, this initiative supports the development of new climate change technologies and strategies for their deployment.
- A \$550-million endowment to Sustainable Development Technology Canada to provide support for the development and demonstration of a wide range of technologies that improve air, water and soil quality and reduce GHG emissions that contribute to climate change. Funding allows the private sector to take innovative R&D out of the laboratories and into the field, where technologies can be proven and deployed.
- Partnerships with Canadian research centres and the private sector in world-leading projects such as the University of Regina's Petroleum Technology Research Centre's project on CO₂ monitoring and storage near Weyburn, Saskatchewan. Endorsed by the International Energy Agency, this project is leading the way toward future innovation in the capture and storage of carbon dioxide.

In addition, the Government has indicated that Canada's largest industrial emitters of GHGs will be able to make investments in approved technology investment funds to meet part of their emission reduction obligations under Canada's Climate Change Plan. These funds will focus research, development and deployment activities in these sectors to facilitate the longer-term transformation needed to meet Canada's ultimate GHG reduction goals.

Accessing R&D From Other Countries Raises Canadian Firms' Technology Intensity

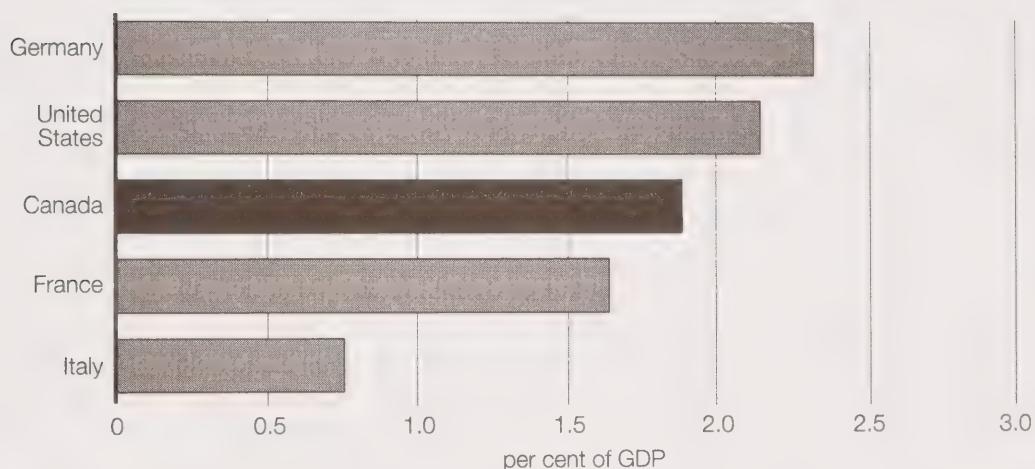
In addition to directly performing research, Canadian firms gain access to foreign R&D by purchasing licences and paying royalties to access the technologies resulting from the R&D investments of foreign firms. In a small, open economy, these forms of technology transfer, along with foreign direct investment, are essential mechanisms for raising productivity levels.

Statistics Canada has quantified the technology intensity of countries by combining domestic private sector direct investment in R&D with an estimate of the R&D that is acquired through licences and royalty payments for foreign technology.

Compared to the United States, if only domestic private sector R&D is measured, the technology gap is 50 per cent in favour of U.S. businesses. The inclusion of R&D embedded in foreign-source patents and technologies accessed by Canadian firms increases the GDP share of Canada's private sector R&D by as much as 80 per cent. Taking this broader view of research and technology intensity suggests that while Canadian firms have scope to increase their investments to catch up with the leaders, the gap is much narrower once the benefits of technology adoption are taken into account.³

Canada's Private Sector Technology Intensity Is Increased by Licensing Foreign Technologies

Total Knowledge Use
(Business Expenditures on R&D Plus R&D From Foreign Technologies)



Source: John Baldwin, Desmond Beckstead and Guy Gellatly, Statistics Canada, "Canada's Expenditures on Knowledge Capital" (2004).

Accessing knowledge developed in other countries raises the technological capabilities of firms and is another reminder of the importance of openness to economic performance. It is also complementary to direct R&D investments because firms that perform R&D and employ workers with advanced scientific and engineering skills are best placed to successfully adopt technology developed elsewhere. But for a leading economy there is no substitute for firms also developing their own innovations—initiating rather than imitating.

³ John Baldwin, Desmond Beckstead and Guy Gellatly, Statistics Canada, "Canada's Expenditures on Knowledge Capital" (2004).

BROAD POLICY DIRECTIONS**Encouraging Private Sector R&D and Technology Adoption**

- ✓ The Government will build the right investment environment as outlined in Chapter 7.
- ✓ The Government will further improve the tax environment that supports innovative activities.
- ✓ The Government will introduce new programs to enhance existing support for technology development and adoption.

4. Accelerating the Commercialization of New Technologies

Improving the diffusion of discoveries from university and public research will raise firms' innovation performance. Canada's strong foundation in primary research provides an opportunity for our firms to be the first to develop and market new innovations. As Canadian universities collaborate more with institutions in other countries, they can diffuse this broader pool of knowledge to our firms.

The commercialization output of university research is generally measured by the number of licences granted, the revenues from these and the number of start-up companies created with university-developed technologies. Canadian universities perform about as well as U.S. institutions in creating intellectual property from their research. Canadian and U.S. institutions also create close to the same number of licences per research dollar and have similar proportions of licences that are active and yielding income.

However, recent data indicates that Canadian universities receive less income from their intellectual property than U.S. universities. Lower returns to technology licences may be the result of Canadian companies commercializing these discoveries in a smaller national market, rather than introducing their improved products and services to broader markets outside of Canada. Once again, developing a global orientation may be important. Canadian universities also rely relatively more on start-up companies to bring their discoveries to the market, whereas institutions in the U.S. take greater advantage of existing firms. As Canada's technology-intensive sectors grow, this trend may change as existing companies provide a larger receptor capacity for university-based discoveries.

Universities have begun to allocate more resources to commercialization activities and incorporate technology transfer goals into their strategic plans. In Budget 2004, the Government announced two pilot initiatives aimed at improving the commercialization of discoveries emerging from universities and federal laboratories, and the three granting councils are tripling their support for the commercialization of their sponsored research by 2006-07.

Canada Has an Opportunity to Create More Value From University Technology Creation

Creation of Technology Licences and Licence Income
(U.S. Performance = 1)

Canadian performance relative to U.S.

1.2

1.0

0.8

0.6

0.4

0.2

0

1991 1993 1995 1997 1999 2001 2003

Canadian income-
yielding licences per
million dollars in
research expenditure

Canadian licence
income per income-
yielding licence

Source: Department of Finance Canada, with data from AUTM Licensing Survey (fiscal year 2003).

Strengthening linkages between university researchers and firms, so that knowledge flows more smoothly from the research environment to the private sector, will enable Canada to benefit more from its leadership in primary research. Improving the flow of people between universities and companies will further enhance private sector capture of intangible and applied knowledge by providing companies with individuals who have the research know-how, experience and networks needed to take better advantage of primary research outcomes.

Linking Government Labs With Universities and the Private Sector

In July 2005 the Government announced that Natural Resource Canada's CANMET Materials Technology Laboratory (CANMET-MTL) is moving to new state-of-the-art facilities in Hamilton's McMaster Innovation Park.

The relocation will position CANMET-MTL within an existing cluster of industries and research organizations, and will contribute to the competitiveness of the value-added metal products sector in Canada.

CANMET-MTL conducts research to assist Canadian industry to develop innovative materials and technology solutions. The laboratory's research is focused on the transportation, construction and energy industries.

The transfer of knowledge between other public research institutions and the private sector can also be improved. Co-locating government research laboratories with universities and closer to concentrations of related industries can improve knowledge transfer and collaboration.

Government laboratories raise the technological capabilities of several key sectors, including agriculture and agri-food. The Government's efforts in improving market access and helping sectors adjust to unexpected economic shocks also contribute to better commercialization performance.

Building an Innovative Agriculture and Agri-Food Sector

Over the last five years, labour productivity growth in agriculture averaged 6 per cent annually. Exports in the agri-food sector have grown at an average annual rate of 5 per cent, rising to roughly \$30 billion in 2004. However, in recent years, farmers have been beset by declining output prices, rising input costs and successive agricultural crises, including drought, bovine spongiform encephalopathy (BSE), avian influenza and flooding. Together, these factors have resulted in record-low farm income in 2003, although incomes rebounded in 2004.

Governments have responded with record-level support to farmers. This is an interim solution. Looking forward, the Government of Canada is committed to ensuring the long-term sustainability of the agriculture and agri-food sector. In order to achieve this objective, the sector will have to undergo a significant transformation. To assist in this transformation, the Government will focus on the following priorities:

- Levelling the international playing field, so that producers and processors from all countries can compete fairly. In particular, the elimination of all export subsidies, a reduction of domestic support and increased access to foreign markets need to be achieved. The Government of Canada is working to maintain the ability of Canadians to choose how to market their products domestically.
- Enhancing competitiveness through innovation. To this end, and in cooperation with all stakeholders, a review of the science and research activities of Agriculture and Agri-Food Canada will be undertaken.
- Ensuring that effective business risk management programming is available.

These efforts are aimed at strengthening the competitive underpinnings of the agricultural sector and sustaining rural communities.

BROAD POLICY DIRECTIONS

Accelerating the Commercialization of New Technologies

- ✓ The Government will respond to the recommendations of Industry Canada's Expert Panel on Commercialization. Measures will be taken to:
 - Increase the commercialization capacity of established clusters of economic activity.
 - Improve collaboration between university and private sector researchers.
 - Strengthen the management and commercial capabilities of scientists and engineers.
- ✓ The Government will implement new models for managing government laboratories to strengthen clusters of university and private sector research excellence.

At the Centre of Global Commerce and Networks

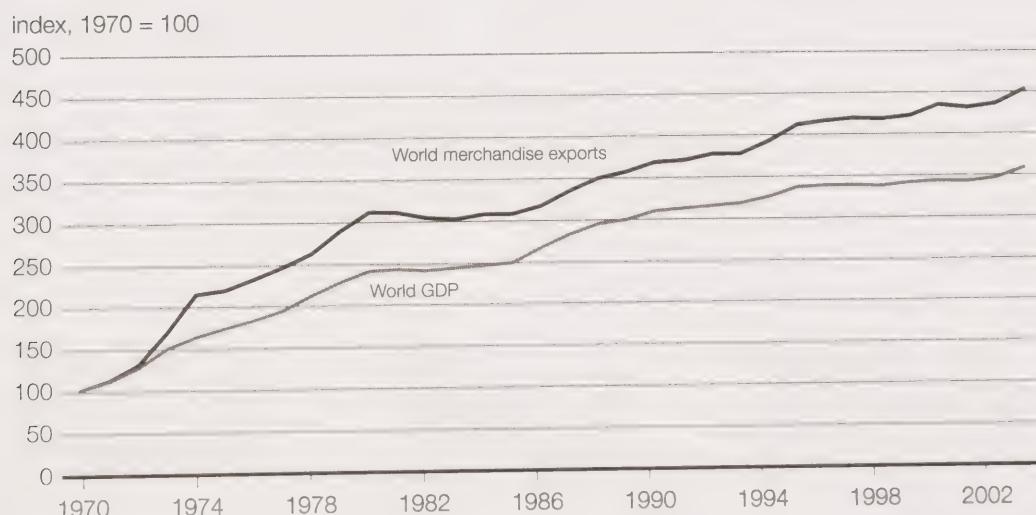
OVERVIEW

By almost every measure, the economies of the world are now more deeply integrated than ever before. Goods, services and capital—and increasingly people and ideas—move more freely across borders. Firms think, plan, invest and produce in terms of opportunities around the world. Production is now global and sliced into finer, more specialized processes. The scope of international commerce continues to increase at a pace that shows no signs of slowing.

The evidence of our interdependence is everywhere. Since the 1970s world exports have grown more quickly than world GDP, and foreign investment has grown more rapidly than trade. Economic weight is shifting and competition intensifying as emerging giants such as China and India open their economies and increase their presence on the world stage. Countries that have open markets, an outward orientation, and the agility to seize opportunities at an early stage will succeed.

Governments play an important role in opening markets and facilitating the global reach of business. They do this through a combination of policies aimed at reducing barriers to trade and capital flows, attracting investment and supporting commerce through modern transportation and communication networks. Over the next few years, Canada needs to broaden and deepen its commitment to openness. Global supply chains will require frictionless exchange of people, capital, goods and ideas. Pursuing globally focused policies will help Canadian industries to achieve a central role in the growing international networks that are essential to our future prosperity.

Trends in World Merchandise Exports and GDP



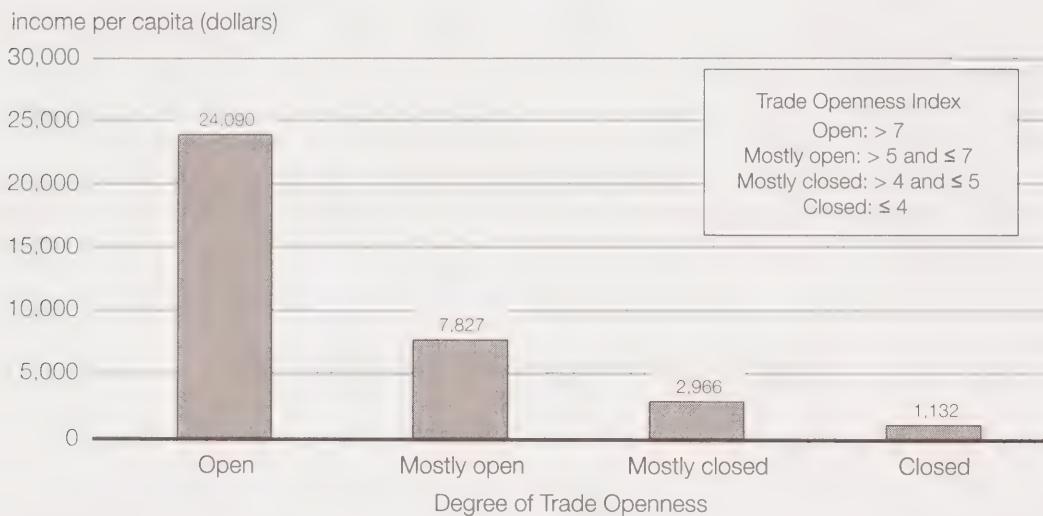
Sources: World Trade Organization; United Nations, Statistics Division.

RELATIONSHIP TO PROSPERITY

In a major study,¹ the OECD identified openness to trade and investment as an important source of competitive strength, stimulating efficiency and, in turn, contributing to economic growth and rising incomes.

The case for openness to foreign investment is as compelling as the case for openness to trade. More open economies enjoy higher rates of private investment, a major determinant of economic growth. Foreign direct investment, in particular, is actively sought by successful economies, not just to augment domestic investment but also because it has the potential to transfer better technologies and improved management practices.

Countries That Are More Open to Trade Generally Enjoy Higher Income



Note: The Trade Openness Index, which ranges from 0 to 10, comprises four components: tariff rates, the black market exchange rate premium, restrictions on capital movements and the actual size of the trade sector compared to the expected size.

Sources: World Bank; Fraser Institute, *Economic Freedom of the World: 2001 Annual Report*.

¹ OECD, *Open Markets Matter—The Benefits of Trade and Investment Liberalisation* (1998).

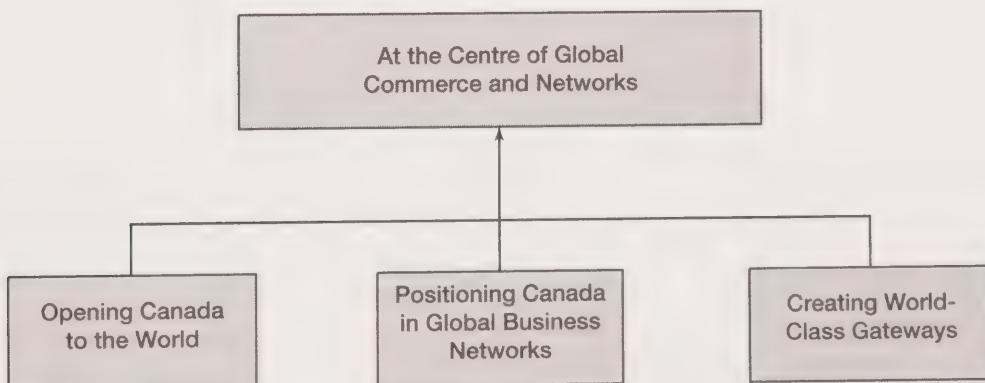
Market Openness Drives Growth and Raises Living Standards

An open trade and investment regime:

- *Provides better access to global markets* for firms to both buy and sell products and services.
- *Counters the disadvantages of a small domestic market* by achieving economies of scale and greater specialization of the production process.
- *Ensures a more efficient allocation of resources* so that each country can specialize in what it does best.
- *Increases the incentive to innovate*, as rewards from innovation are much greater in a larger market.
- *Transfers new technologies* either directly through goods and services that incorporate new technologies, or indirectly through new production processes and techniques.
- *Strengthens industries* through exposure to foreign competition.
- *Connects firms to global networks* through partnerships, alliances and other forms of organization.

For Canadian consumers, open markets and free trade mean a wider range of goods and services of a higher quality at better prices, effectively raising the real standard of living.

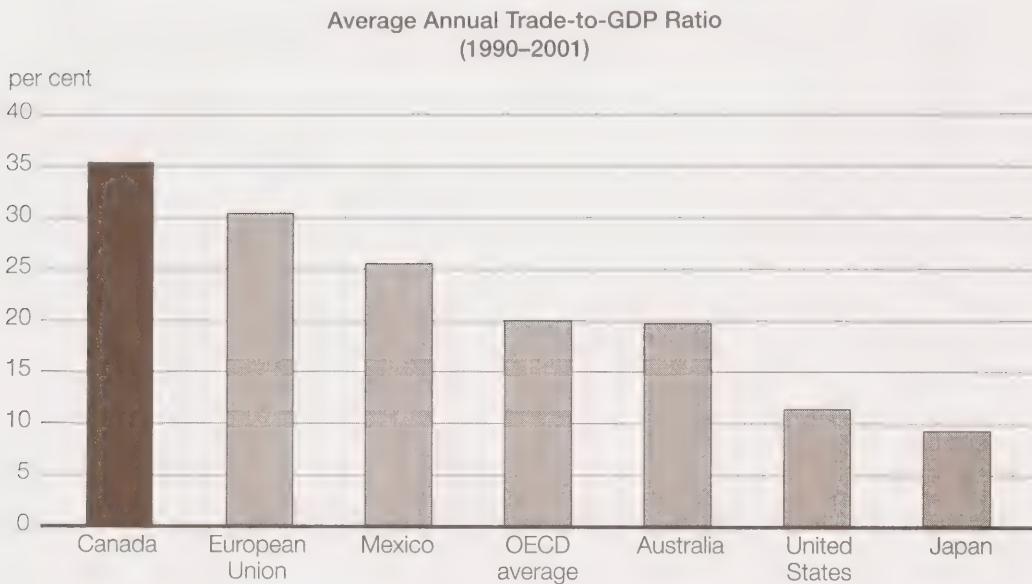
At the Centre of Global Commerce and Networks



RECENT PERFORMANCE AND BROAD POLICY DIRECTIONS

Canada is one of the world's most open economies, and trade is a key foundation of our prosperity. We are the world's fifth largest trader and our exports account for close to 40 per cent of our GDP. Compared to both our North American Free Trade Agreement (NAFTA) partners and other G7 nations, trade accounts for a larger share of Canada's output. Our exposure to trade is also growing more quickly than that of other major developed countries.

Canada Trades a Large Share of Its Production



Note: The trade-to-GDP ratio is the average share of exports and imports of goods and services in GDP.

Sources: OECD; World Bank.

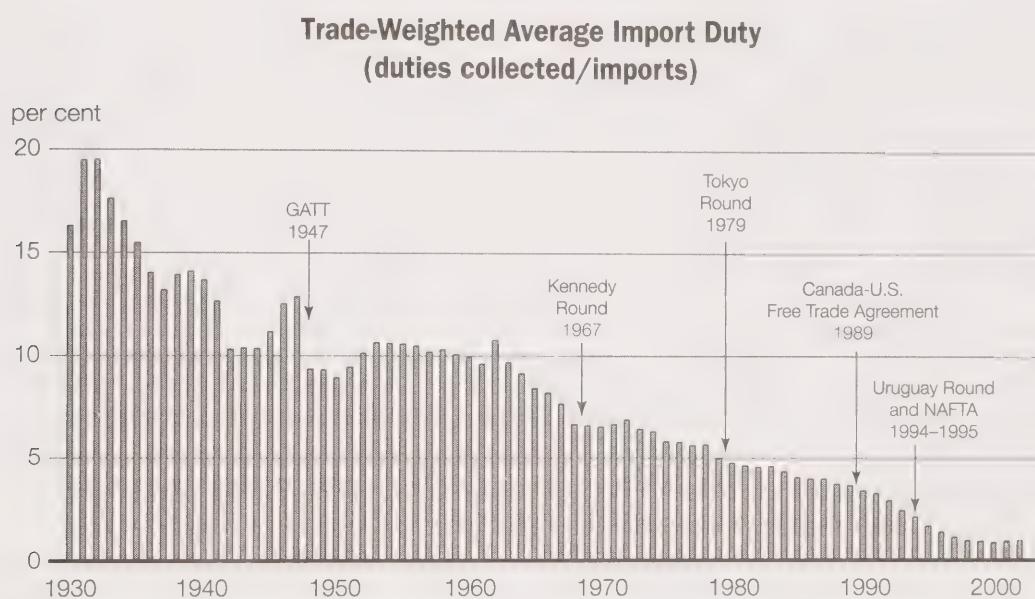
While Canada has long benefited from trade, including the economic gains of NAFTA, many Canadian industries still lag behind their U.S. counterparts in terms of productivity (see Chapter 3). Of note, many sectors where Canada's productivity is well below U.S. levels are characterized by a weaker competitive business environment, which is in turn partly the result of above-average tariffs and other barriers to trade and investment.

Canada's future success will depend, in part, on policies that open the domestic market to competition. This will help promote innovation, jobs and growth.

1. Opening Canada to the World

Trade Liberalization

The economic case for improving market openness is strong. Canada, as a founding member of the General Agreement on Tariffs and Trade (GATT) in 1947 and its successor, the World Trade Organization (WTO) in 1994, has reduced its tariffs in exchange for reciprocal reductions by other countries. As a result of successive rounds of trade liberalization over the last 60 years, the average trade-weighted tariff of developed countries is less than 3 per cent.



Sources: Statistics Canada; *Public Accounts of Canada*.

A successful conclusion of the current WTO Round of multilateral trade negotiations, known as the Doha Round, would further open markets and allow Canadian industries to expand and diversify their sales internationally. But success is not guaranteed. Strong leadership and political will by the United States and the European Union will be required to make progress in removing trade distortions in the agricultural sector, which is key to a successful outcome. Canada is working hard to do its part to secure an ambitious result that will reflect the interests of all segments of Canada's business and agricultural communities.

While global progress in trade liberalization is often slow and incremental, there have been encouraging developments. China joined the WTO in 2001 and has since significantly opened its market. Average tariffs in China are now only slightly higher than in developed countries and much lower than in most other developing countries. Other countries, such as India, have recognized the benefits of open markets and have moved unilaterally to liberalize their markets without seeking reciprocal concessions from their trading partners.

Canada also cannot afford to stand still. Despite having one of the world's most open economies, Canada continues to maintain tariffs on many goods imported from outside North America, including on inputs and capital goods. There is a need to further modernize our tariff structure to improve our competitiveness. Beyond the obvious market access benefits, an ambitious result in the Doha Round would go a long way in improving our existing tariff structure. However, depending on the outcome of the Doha Round, further steps may be required to enhance the competitive position of Canadian firms, in particular by reducing tariffs on inputs and capital goods.

Making Trade Agreements Work

Canada's prosperity depends on our ability to compete in international markets. For this reason Canada has always been a strong supporter of market liberalization and a rules-based trading system. Current efforts are focused on the successful completion of the Doha Round of the WTO, enhancing trade with our most important partner, the United States, working with our NAFTA partners to increase North American competitiveness, and pursuing bilateral trade and investment agreements with key partners. Free trade negotiations are currently underway with important trading partners such as South Korea, which is a strategic gateway to Asian markets, and Foreign Investment Promotion and Protection Agreements are being negotiated with China, India and Peru.

A rules-based trading system means that Canada, like all of our trading partners, must take action to ensure that countries abide by the rules and obligations as set out in international agreements. This includes, on occasion, invoking dispute settlement procedures to address differences and, as a last resort, exercising our international rights to obtain appropriate remedy from countries that are not abiding by the rules.

When countries have to take retaliatory action in response to illegal measures by other countries, as Canada and other countries did against the U.S. on the so-called Byrd legislation, the benefits of the system are put at risk, to the detriment of all. Given their importance and benefits, it is vital that our trading partners abide by the rule of law and the principles of international agreement. Only in this way can we ensure the willingness of all countries to engage in the bargain of multilateral trade liberalization.

Improving North American Opportunities

The North American market remains Canada's priority, and continued success in this market is vital to our prosperity. The Canada-U.S. Free Trade Agreement and NAFTA created a liberalized North American market space, and the United States remains by far our largest trading partner, accounting for around 80 per cent of Canadian exports. At the same time, we must look outward from our position within the integrated North American market to ensure our proper place in global markets. This requires that we continue to make progress on a range of trade and border efficiency issues, so that we can compete from a position of strength. The Security and Prosperity Partnership of North America, announced by Prime Minister Martin, President Bush and President Fox in March 2005, is an important initiative in this regard.

Security and Prosperity Partnership of North America

The task is "to create an architecture which would further enhance the security of North America while at the same time promote the economic well-being of our citizens and position North America to face and meet future challenges."

*Security and Prosperity Partnership of North America—
Report to Leaders, June 2005*

The Partnership provides a pragmatic and forward-looking agenda for action that will promote a more coordinated policy approach based on the mutual dependence and complementary nature of our security and prosperity.

The first report to leaders under the Partnership identified initiatives centred around a range of key objectives: expanding trade liberalization, enhancing competitiveness in key sectors, streamlining regulatory processes, supporting the e-commerce marketplace, strengthening capital markets and ensuring faster and more efficient border crossings.

This Partnership is a significant step forward in our NAFTA relationship. It reflects the fact that the vast majority of trade within North America flows freely. But differences do occur and when these cannot be resolved through consultation, dispute resolution processes are employed and their conclusions must be respected. Canada has challenged U.S. actions on softwood lumber using the NAFTA dispute settlement process. Despite a unanimous victory for Canada in a final and binding NAFTA decision, the United States continues to impose duties on Canadian softwood lumber. Canada continues to press the United States to abide by the NAFTA rulings and to maintain the integrity of the NAFTA. In the meantime, the federal government, along with its provincial partners, will continue to vigorously defend the interests of our softwood producers. This will include continuing our challenges in U.S. courts to remove the illegal duties and reimburse Canadian softwood exporters.

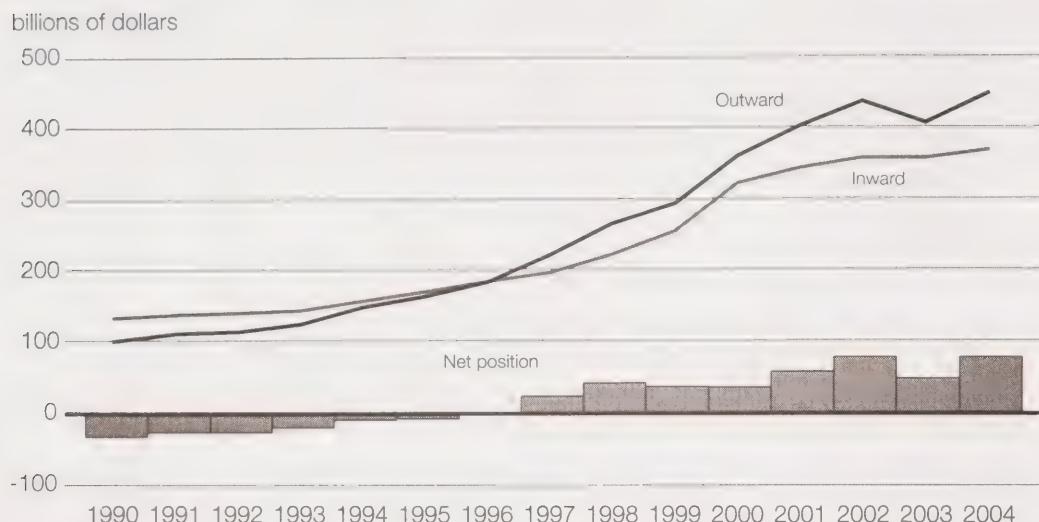
Foreign Direct Investment

Since the early 1980s, global capital flows have been growing tremendously. The accumulated stock of world FDI is now over US\$8 trillion.

Canada has long been a net recipient of international investment. In recent years, however, Canadians have been investing more abroad than foreigners in Canada. As a result, Canada's position as a net international investor has been steadily improving.² In terms of FDI, Canada is already a net foreign investor. This strengthening position in terms of direct investment abroad is important in order to effectively connect Canadian firms to global supply networks and create opportunities at home and abroad.

² International investment includes direct investment, portfolio investment, loans and official international reserves. Direct investment requires a degree of control by the investor, defined as 10 per cent or more of the ordinary shares of voting stock. Portfolio investment excludes shares which confer such control, but includes a wide range of other assets, including bonds.

Canada's International Direct Investment Position



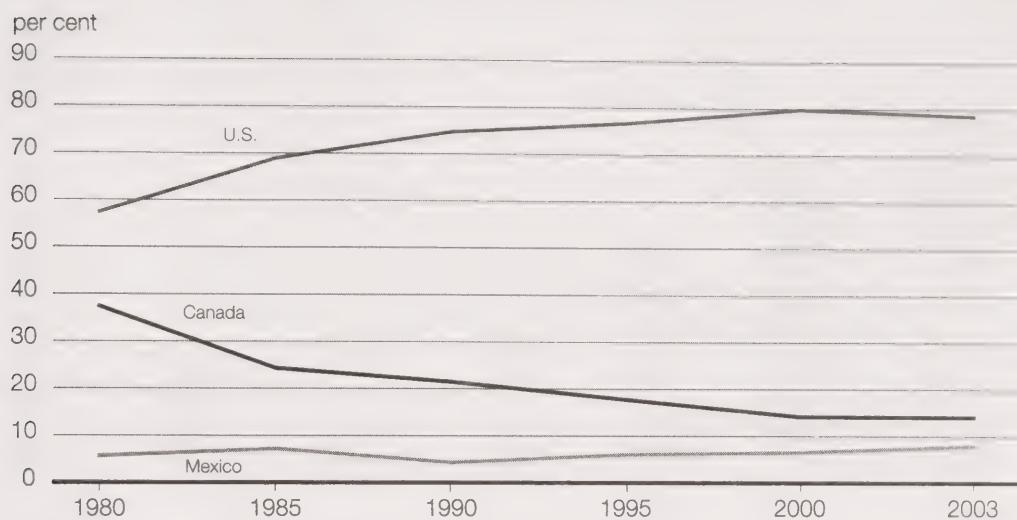
Source: Statistics Canada.

While the United States remains the major destination for our international investment, Canadian direct investment abroad has become more diversified since the late 1990s, in part reflecting the growing dynamism and market openness in Asia.

As Canadian firms increase their investments in foreign markets, Canada will need to ramp up its Foreign Investment Promotion and Protection Agreement program to safeguard Canadian interests and ensure a level playing field for Canadian firms.

Canada continues to attract FDI; however, international competition has intensified and our share of North American inward FDI stocks has declined. While this trend is expected to improve as a result of FDI inflows to Canada's oil and gas sector, the challenge for Canada is to maintain a modern FDI regime and the right investment environment (discussed in Chapter 7).

Canada's Share of North American Inward FDI Stocks



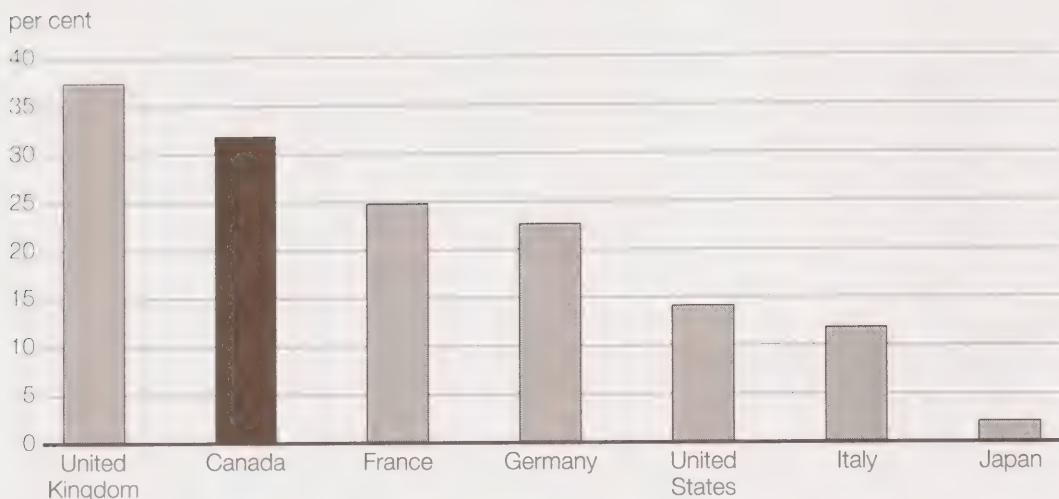
Source: United Nations Conference on Trade and Development (UNCTAD).

Currently, foreign investors perceive Canada as having a less attractive investment environment than most other OECD countries, in part due to investment-screening requirements and restrictions on foreign personnel and operational freedom.³ The high level of foreign ownership in the Canadian economy (as measured by the share of FDI in our GDP) would suggest that the effective differences between Canada and its G7 partners with respect to investment restrictions are more perception than reality. Nonetheless, perceptions often drive behaviour, so we need to improve the signals we send to international investors.

³ OECD, *Economic Survey of Canada* (2004).

Inward FDI Accounts For an Important Share of Our GDP

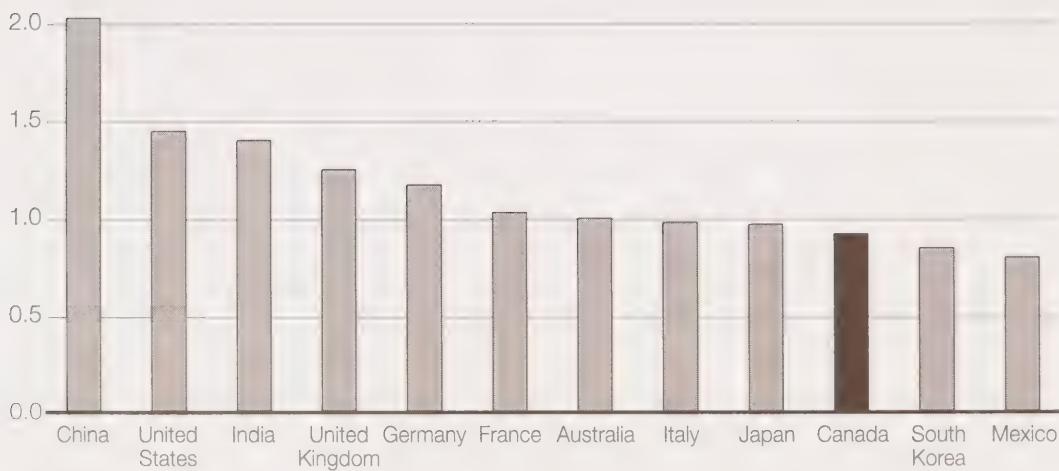
Inward FDI Stocks as a Percentage of GDP, 2003



Source: UNCTAD.

Canada Needs to Improve How It Is Perceived by International Investors

FDI Confidence Index®, 2004



Note: The FDI Confidence Index® was designed to gauge the likelihood of investment in specific markets and is calculated on a scale of 0 to 3, with 3 representing high confidence and 0 low confidence. The index is based on a survey of the perceptions of chief executive officers from the world's leading companies on how likely political, economic and regulatory changes will impact their FDI intentions and preferences. The survey covers 65 countries receiving more than 90 per cent of global FDI flows. The companies surveyed account for about 70 per cent of global FDI flows. Canada ranked 16th on the 2004 index. The chart shows a selection of the top-ranked countries.

Source: A.T. Kearney.

Canada needs to ensure that our relatively stringent ownership restrictions in telecommunications and transportation—two important “enabling” sectors—do not put us at a disadvantage vis-à-vis our major economic partners. Recently, the Government tasked the Telecommunications Policy Review Panel to provide recommendations, which may include consideration of foreign ownership limits in the telecommunication sector. The Government has also indicated its intention to review foreign ownership restrictions in the airline sector.

The free flow of global portfolio capital is an important feature of today’s economy. It is the consequence of increased liberalization but also reflects changing investor preferences and better information. Vast improvements in information and communications technologies have broadened investors’ scope for investment. At the same time, the increased international tendency for open, transparent financial systems that support strong investor protection appears to be reducing home bias. Canada needs to capitalize on and reinforce these trends. In Budget 2005, the Government eliminated the Foreign Property Rule, which limited the foreign content of Canadian registered pensions and registered retirement savings plans to 30 per cent, thereby removing an important and outdated restriction on capital.

Canada’s tax treaties are also an important part of the global environment for Canadian business, with the Canada-U.S. income tax treaty having a particular significance. The Government is seeking to update that treaty and others to ensure that they continue to facilitate international investment.

BROAD POLICY DIRECTIONS

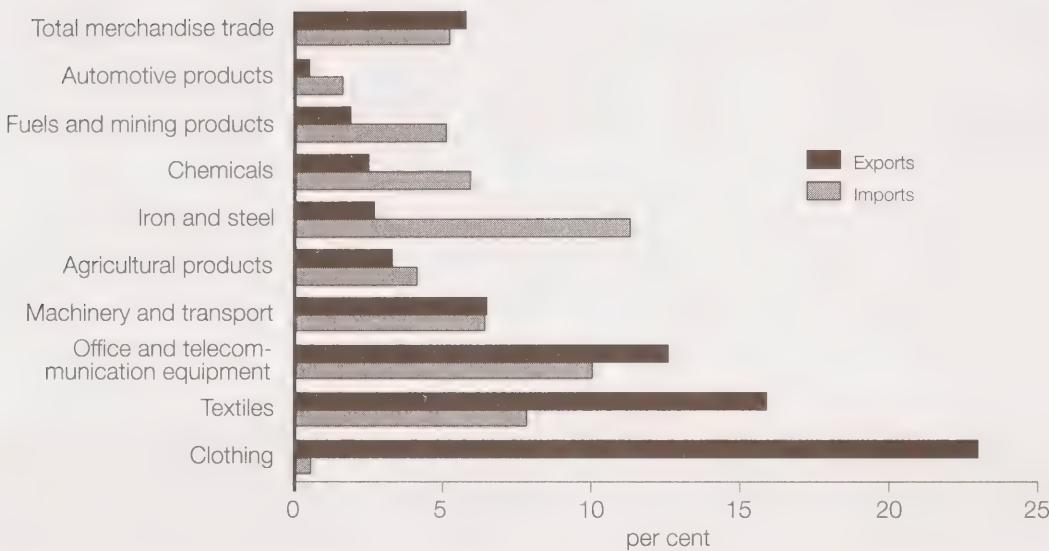
Opening Canada to the World

- ✓ The Government will review Canada’s tariff regime to improve competitiveness and attract investment, for example by reducing tariffs on manufacturing inputs. The Government will continue to pursue trade negotiations that open key international markets for Canadian business.
- ✓ The Government will move forward with the Security and Prosperity Partnership of North America to make our societies safer and more secure, our businesses more competitive and our economies more resilient.
- ✓ The Government will ramp up its Foreign Investment Promotion and Protection Agreement program to assist firms in connecting to global supply networks. Ongoing negotiations with India and China are a priority.
- ✓ To improve our trade and investment climate, the Government intends to conclude negotiations with the U.S. on tax treaty changes, review Canada’s restrictions on foreign investment in the air transportation sector and act on the findings of the telecommunications review.

2. Positioning Canada in Global Business Networks

The shifting balance of economic power in the world is one of the fundamental forces reshaping Canada's economic future. Emerging economic giants like China and India are positioning themselves in the ranks of "knowledge superpowers," aiming to join the U.S., the European Union and Japan as poles of production, innovation and investment. In the not-too-distant future, China and India will not merely participate in global supply chains based on Western technology or managerial know-how, they will increasingly shape them.

China's Share in World Trade in 2003



Source: WTO.

Canadians rightly celebrate the successes of these countries. They have overcome enormous obstacles to set themselves on a strong path of growth and development. Through our position in the G7 and our role in creating the G20, Canada has done much to assist integration of these emerging giants into the global economy and to encourage them to fulfill their associated responsibilities. As stressed in the Martin-Zedillo report on unleashing entrepreneurship in developing countries, which was co-authored by the Prime Minister, and the Commission for Africa report co-signed by the Minister of Finance, private sector development is essential to lift nations out of poverty. Canada is committed to helping developing countries create the institutions and the capacity to build vibrant private sectors.

Canadian industry has already benefited economically from the rise of China and India. Global commodity prices have strengthened as a result of increased demand from these countries and China is now Canada's fourth largest export market (over \$6 billion in 2004). While this economic relationship is small in comparison to our economic ties to North America, the potential for Canadian business is enormous.

Our ability to capitalize on trade opportunities in these markets is largely a function of our vibrant private sector, though government has an important role to play in supporting Canadian industry. The challenges are not insignificant. The Government will respond with a strategy aimed at assisting Canadian firms, especially small and medium-sized enterprises, in identifying market opportunities, showcasing Canadian strengths and winning results. These actions will build on our ongoing efforts to expand market access through trade and investment negotiations.

Taken together, our efforts to expand commercial opportunities in these markets will require a rethinking and refocusing of the Government's efforts and resources dedicated to trade promotion, advocacy and other trade-related programs and services. Instruments such as science and technology cooperation agreements, as well as efforts to protect Canadian intellectual property, are key examples of the new types of tools government must promote in assisting industry in effectively linking to expanding global supply networks. Getting more people on the ground in China, India and Brazil will also be necessary to gather market intelligence and work with local authorities on regulatory or other business requirements so that Canadian firms can focus on commercial results.

Canada must move now to make this happen. Many other countries have already expanded their support of small and medium-sized businesses through new export promotion and market development services.

To assist in redefining our approach to these markets, Canada is fortunate to have a diverse multicultural population that is a competitive advantage in accessing opportunities in emerging markets. Many Canadians have cultural, family and business ties to China, India and other emerging economies. Their knowledge of the language, culture and business environment can be key to building lasting commercial relationships. Both businesses and government need to draw more effectively on this pool of talent to build trade and investment ties and help modernize the image of Canada in emerging markets.

The importance of corporate social responsibility cannot be lost in our quest to expand economic opportunities abroad. We must take action to ensure our economic ties foster social, economic and environmental progress for communities in emerging countries. In this regard, the Government has a role to play in working with the private sector to promote appropriate norms of corporate behaviour.

Promoting New Markets for Canadian Companies and Environmental Technology

The Kyoto Protocol, under which Canada committed to reducing its emissions of greenhouse gases to 6 per cent below 1990 levels by 2008–12, includes as a compliance option the purchase of international credits. These credits will contribute to the economies of developing countries and provide new markets for Canadian companies and technologies.

The Government of Canada will use the \$1-billion Climate Fund, announced in Budget 2005, to purchase domestic and international carbon reduction credits to help Canada meet its greenhouse gas emission targets. Canada's investments in international emission reduction projects will support other policy objectives by having at least one of the following characteristics:

- Apply Canadian technology.
- Improve Canada's international competitiveness.
- Expand Canada's trade or otherwise advance our national interest.
- Advance Canada's international development objectives.

The use of innovative instruments such as international credits to help address climate change demonstrates that dealing with environmental issues can also present significant economic opportunities for companies that develop and implement environmental technologies.

BROAD POLICY DIRECTIONS

Positioning Canada in Global Business Networks

- ✓ A government-wide network of services and programs will be developed to identify opportunities in key emerging markets, showcase strengths and achieve results through successful commercial strategies.
- ✓ To better position Canadian small and medium-sized enterprises in emerging markets, the Government will increase its export promotion efforts.
- ✓ The Government will work to further the integration of emerging economies into the global economy through bilateral initiatives and our leadership position in the G7 and G20.
- ✓ The Government will also work with Canadian businesses in emerging markets in promoting issues of corporate social responsibility.
- ✓ Facilitate global market opportunities for Canadian companies to develop and deploy environmental technologies through the United Nations Framework Convention on Climate Change and other international processes.

3. Creating World-Class Gateways

To succeed, firms must operate in networks where information is rapidly exchanged and where sourcing, production and distribution decisions can be made seamlessly. Canada needs to have state-of-the-art transportation and telecommunication services and to exploit more fully both its privileged location vis-à-vis the United States and its proximity to emerging Asia-Pacific countries.

Strategic Transportation Gateways

Countries are linked to their trading partners by "gateways," where land, marine and air transportation networks converge to connect centres of economic activity. One of Canada's key gateways involves the border crossings at Windsor, which account for about 35 per cent of Canada-U.S. trade by truck. The transportation facilities situated on Canada's Pacific Coast represent another important trade gateway. The Pacific gateway is well positioned to play an especially important role in facilitating future trade between Asia-Pacific countries and North America. Further development of these gateways will benefit not just local economies and those who use their facilities, but all Canadians will benefit as well from more efficient trade and increased economic activity.

The private sector and the provinces are planning substantial investments to enhance the capacity and the quality of infrastructure at these gateways. Capitalizing effectively on linkages to expanding markets will require a broad approach, involving issues such as trade strategy, the flow of people, border management and transportation. For its part, the Government of Canada can support the efficient functioning of key gateways by ensuring that appropriate policies are in place and by making strategic investments in transportation infrastructure. This will involve close coordination between all levels of government, other jurisdictions and the private sector to select the most productive investments and to ensure that facilities in place are used efficiently.

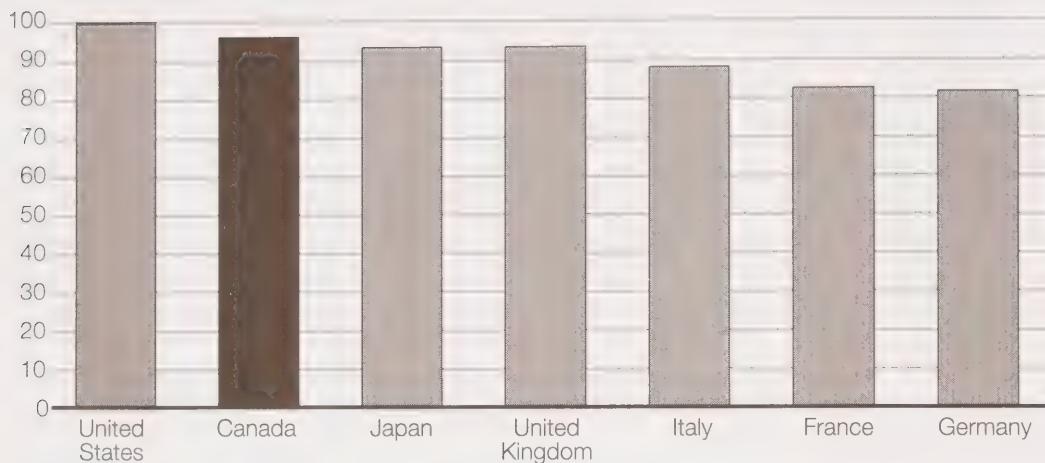
Air transportation also has a crucial role in trade since it is essential to the transportation of people and time-sensitive cargo over long distances. Because of this critical role, Canada will endeavour to make its international air transportation markets more accessible. Fewer restrictions in these markets would provide new opportunities for airports and air service providers, as well as more choices and lower prices for travellers and shippers alike.

Broadband and Connectivity

It is important that all regions of Canada have access to the telecommunication networks that enable the rapid exchange of information among firms, suppliers and consumers that increasingly characterize the global economy. Canada is among the most connected nations in the world, measured by access to broadband and other Internet services. Nearly all Canadian households now have access to high-speed Internet services—over 85 per cent in 2003. The Conference Board also ranks Canada second in terms of availability of information and communications technology services among the G7 countries, behind only the U.S.

**Index of Availability of Information and Communications Technology Services,
G7 Countries, 2003**

Index of ICT Availability (U.S. = 100)



Source: Conference Board.

While access is high overall in Canada, there remains a significant difference between availability of broadband services in urban and rural areas, with 95 per cent of urban markets having access to broadband services compared to less than two-thirds in rural areas. This is of concern, because it limits the ability of those living in rural areas to participate fully in the new economic relationships and productivity gains offered by the networked economy.

BROAD POLICY DIRECTIONS

Creating World-Class Gateways

- ✓ To promote trade opportunities with the United States and emerging Asia-Pacific economies, the Government will work with public and private partners to support the further development of Canada's Pacific gateway and Windsor-Detroit corridor through strategic infrastructure investment and supporting policy initiatives.
- ✓ Air liberalization encourages enhanced market access, service and competition in the air transport sector. The Government will explore further liberalization of its air transport agreement with the United States and, over time, with other countries.
- ✓ To improve Canada's access to global telecommunication networks, the Government will invest to better connect remote, rural and Aboriginal communities to broadband networks where private service is lacking.

Building the Right Investment Environment

OVERVIEW

We live in a global economy where people and businesses are increasingly able to move to where they obtain the greatest advantage. Skilled workers are locating in those places where their talents are most rewarded, where they can fully achieve their aspirations, and where they can experience the highest quality of life.

Similarly, for businesses, technological advances are lowering the costs of transportation and communications worldwide, permitting firms to invest where they can be most productive and can find the best combination of skills, investment opportunities and business environment.

In this context, governments play a critical role by establishing the right policy framework to encourage productive investment in those factors that support long-term prosperity: education and training, physical capital and innovation.

RELATIONSHIP TO PROSPERITY

The right policy framework begins with a sound macroeconomic environment. The combination of disciplined monetary policy and prudent fiscal planning lays the foundation for investment by keeping interest rates low and uncertainty muted. Sound macroeconomic policy must be complemented by effective structural policies that address taxation, regulation, financial markets, competition, openness and government efficiency.

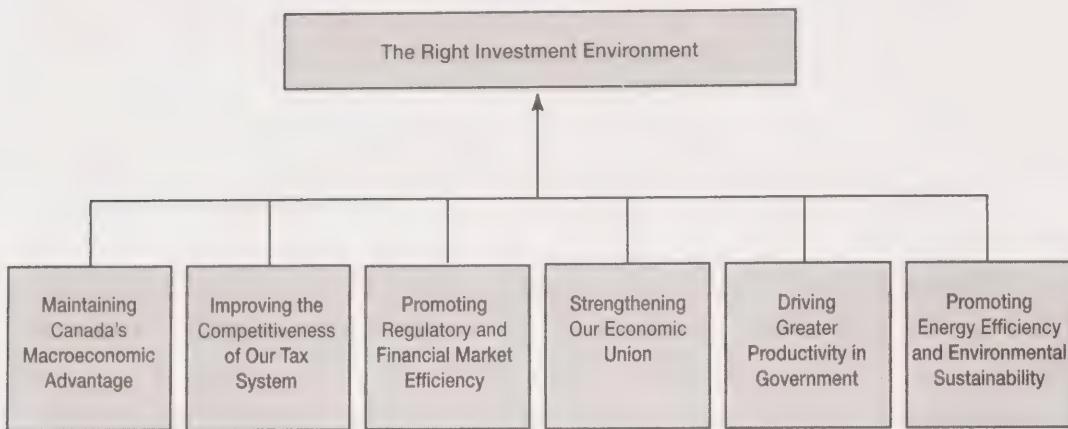
The tax system should be appropriate to raise the revenue needed to pay for the social programs that Canadians value and to support investment in education and basic research. It must also be efficient and competitive to enhance incentives to save, invest and work. This means not only that the tax rates should be as low as possible, but also that the mix of taxes should be economically efficient.

Good regulation is essential to a robust economy. An appropriate regulatory framework helps to protect the health and safety of Canadians and the environment in which we live, at the least possible economic cost.

World-class financial markets, along with open and efficient product markets, play a vital role in creating the right setting for individuals and businesses to invest and promote prosperity in Canada. Competition induced by open markets encourages firms to reach their productive potential.

Finally, the public service plays a key role in ensuring that all of its programs deliver results for Canadians at a reasonable cost. Strong public management and oversight are critical to efficient and cost-effective government, and ultimately to a more prosperous Canada.

Building the Right Investment Environment



RECENT PERFORMANCE AND BROAD POLICY DIRECTIONS

1. Maintaining Canada's Macroeconomic Advantage

Sound macroeconomic conditions are fundamental to a country's prosperity. The combination of effective monetary policy and prudent fiscal planning encourages households and businesses to save and invest, and hence leads to higher growth. Lower debt leaves government finances less exposed to interest-rate fluctuations; it enables government to spend less on servicing debt, freeing resources to fund social programs and to invest in support of economic growth and tax reduction; and it gives Canadians a greater ability to face the challenge of an aging population. Strong fiscal and monetary credibility give the central bank the flexibility to cushion the impacts of negative shocks to the economy.

Fiscal Policy

Eliminating the federal deficit in 1997 was an essential part of restoring the country's economic stability. The Government has now recorded eight consecutive surpluses and has committed to maintaining balanced budgets or better. The federal debt, expressed as a share of the size of the economy, has fallen from a peak of 68 per cent in 1995–96 to 39 per cent in 2004–05, and the Government is on track to meet the goal set out in the 2004 budget of reducing the debt-to-GDP ratio to 25 per cent by 2014–15. The federal effort to put its fiscal house in order has been complemented by similar efforts by the provinces and territories. As a result, Canada was the only G7 country to record a budget surplus for the government sector in 2004. Canada has gone from having the second highest debt-to-GDP ratio among G7 countries in the mid-1990s to the lowest last year. This improved fiscal record laid the groundwork for a more productive allocation of savings by keeping interest rates low and stimulating private investment.

With the aging of Canada's population, the country will face increases in aging-related expenditures, such as elderly benefits and health care. In order to meet these future pressures, it is critical that the Government maintain a steady focus on fiscal discipline and debt reduction over the next several years, before the major impacts of population aging are felt.

Establishing Sound Fiscal Policy Is Crucial to Canada's Prosperity

Federal Debt-to-GDP Projections (Accumulated Deficit)
(Public Accounts Basis)



Source: Department of Finance Canada.

To ensure that the debt burden continues to fall, the Government is announcing a new objective of reducing the debt-to-GDP ratio to 20 per cent by 2020. Reducing the debt-to-GDP ratio to 20 per cent would mean that less than 10 cents of every revenue dollar would go to service the debt compared to about 17 cents in 2004-05 and 39 cents in 1990-91.

Monetary Policy

Inflation targeting is the cornerstone of monetary policy in Canada. Since 1991, the Government and the Bank of Canada have jointly agreed to target inflation—first with the goal of reducing it to progressively lower levels and then, once a low level of inflation was achieved, to keep it low. This strategy has been very successful. Inflation expectations are well anchored at low levels and have remained so even in the face of significant external shocks to the economy. This has provided consumers and businesses with the confidence they need to make long-range plans. By keeping inflation low, stable and predictable, Canada's monetary policy has encouraged businesses to make productivity-enhancing investments, thereby strengthening the growth of the economy and its capacity to generate new jobs.

BROAD POLICY DIRECTIONS

Maintaining Canada's Macroeconomic Advantage

- ✓ Maintaining sound macroeconomic conditions is a key ingredient to ensure a continuing increase in our standard of living. To that effect, the Government reaffirms its commitment to a balanced budget or better and to achieve its debt target.
- ✓ Keeping the federal debt-to-GDP ratio on a downward track will create future fiscal flexibility and help to address the pressures associated with an aging population. Accordingly, the Government of Canada is setting a new objective of reducing the federal debt-to-GDP ratio to 20 per cent by 2020.
- ✓ Canadians have seen the benefits of prudent fiscal planning and a balanced approach that allocates annual fiscal surpluses between debt reduction, tax relief and investments in key economic and social priorities. To maintain this balanced approach, the Government recently introduced legislation to allocate any unanticipated surplus in excess of the \$3-billion Contingency Reserve equally to further investments, tax relief and debt reduction. The annual Contingency Reserve is set aside to guard against unforeseen circumstances. If not needed, it is used to reduce the federal debt.
- ✓ In order to maintain the institutional framework that has delivered low, stable and predictable inflation, the Government intends to extend its inflation target agreement with the Bank of Canada for a further five years in 2006.

2. Improving the Competitiveness of Our Tax System

Taxes finance Canada's strong social safety net, our roads and other public infrastructure, our universal health care system, environmental protection, public safety, the Canadian Forces, and countless other social and economic imperatives, all contributing to our high quality of life. Taxes also have important consequences for economic growth, job creation and our standard of living through their impacts on the incentives to work, save and invest.

Highly skilled and productive workers are critical for success in a knowledge-based global economy. Taxes lower the rewards from investing in new skills, and they can discourage skilled workers from choosing to work and live in Canada. Personal income taxes may also discourage low-income Canadians from working as much as they might want, especially when working more may mean a reduction in, or loss of, income-tested benefits, such as social assistance and the Canada Child Tax Benefit.

Savings are important for growth and prosperity because they provide a pool of investment capital for new and growing businesses. Savings also help Canadians achieve other financial aspirations such as a comfortable retirement, home ownership or higher education. However, personal income taxes can erode the returns to saving outside of registered pension plans (RPPs) and registered retirement savings plans (RRSPs), making it more attractive to consume today rather than to save for tomorrow.

The creation and expansion of enterprises is central to creating more and better jobs for Canadians. In today's global economy, where capital is highly mobile internationally, creating a tax advantage to attract and retain investment is vital. Canada must have a competitive business tax system to encourage the investment that helps workers become more productive and efficient, the cornerstone of higher wages and better living standards. A tax system that is easy for businesses to understand and comply with, and is harmonized among different levels of government, allows businesses to focus on growing their companies and investing in the future.

The Tax Burden and Mix

The economic costs imposed by taxes depend on overall tax levels, as well as the sources of these revenues—the tax mix—because some types of taxes slow growth more than others. Some types of business taxes (e.g. sales taxes on capital goods and capital taxes) and personal taxes on savings are more damaging to Canadians' living standards. Taxes that reduce savings and investment particularly undermine our long-term prosperity.

Overall, Canada is at the G7 and OECD averages in terms of how much revenue is raised as a proportion of GDP. Canada raises more of its revenue as a share of GDP from personal and corporate income tax than any other G7 country (see table below).

Canada Relies More on Personal and Corporate Income Taxes Than Do Other Countries

International Tax Burden Comparisons for Different Revenue Sources as a Percentage of GDP, 2003

	Personal Income Tax	Corporate Income Tax	Social Security and Payroll Tax	Consumption Tax	Other Tax ¹	Total
G7 average	8.9	2.6	10.5	9.0	3.7	34.6
OECD average	9.4	3.4	9.9	11.5	2.1	36.3
Canada	11.7	3.5	5.9	8.8	3.9	33.8
United Kingdom	10.2	2.8	6.6	11.6	4.4	35.6
United States	9.0	2.1	6.7	4.6	3.2	25.6
Japan	4.4	3.3	9.7	5.1	2.8	25.3
France	7.6	2.5	17.5	11.1	4.7	43.4
Germany	8.5	1.3	14.4	10.4	0.9	35.5
Italy	10.8	2.9	12.7	11.1	5.6	43.1

¹ Includes primarily property tax revenue, withholding taxes and provincial capital taxes.

Source: OECD, *Revenue Statistics—1965–2003* (2004 edition).

Personal Income Taxes

Since eliminating the deficit in 1997, the Government has significantly reduced personal income taxes, particularly those of low- and modest-income Canadians. Comparing today's tax system with the one in place in 1997, Canadians face lower marginal tax rates, earn more tax-free income, receive more significant family benefits, and are protected against paying more tax due to inflation.

The \$100-billion Five-Year Tax Reduction Plan, introduced in 2000, reduced federal personal income taxes by 21 per cent on average, and 27 per cent for families with children. To date, about 1 million low-income Canadians have been removed from the tax rolls and the tax system has been improved for students, persons with disabilities, registered charities and others (see box).

Tax Relief for Canadians

In 2000, the Government introduced a plan to reduce federal taxes by \$100 billion over five years—the largest tax cut in Canadian history. The plan provided \$81 billion in tax relief for individuals, over 60 per cent of which went to low- and middle-income Canadians.

Budget 2003 built on that five-year plan by enhancing support for Canadian families, bringing the estimated annual support delivered through the Canada Child Tax Benefit to over \$10 billion in 2007, an increase of more than 100 per cent since 1996.

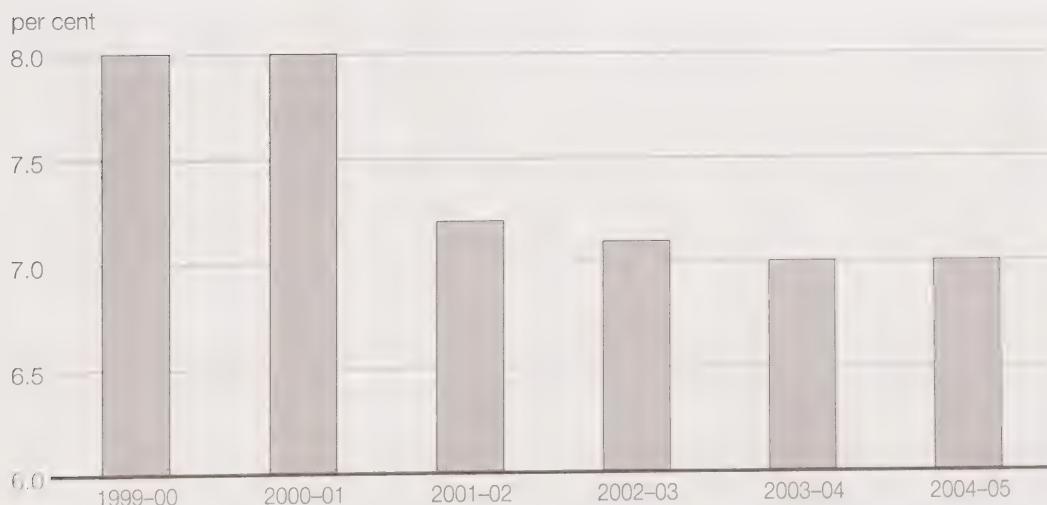
Budget 2005 increased the basic personal amount—the amount that all Canadians can earn without paying federal income tax—to at least \$10,000 by 2009. It will provide about \$7.1 billion in tax relief for all taxpayers over five years, with most of the benefit going to those with low and modest incomes, and remove 860,000 low-income taxpayers from the tax rolls.

Overall, the majority of personal income tax relief since 2000 has gone to low- and modest-income Canadians. For example, a two-earner family of four earning \$60,000 paid about 37 per cent less net federal income tax in 2005 than it would have paid without the 2000 tax plan. A similar family earning \$100,000 paid 18 per cent less.

Past tax relief efforts helped reduce the burden of personal income taxes as a proportion of GDP from 8 per cent in 1999–2000 to 7 per cent in 2004–05 (see chart below).

Personal Income Tax Burden Has Fallen

Federal Personal Income Tax Revenues as a Percentage of GDP

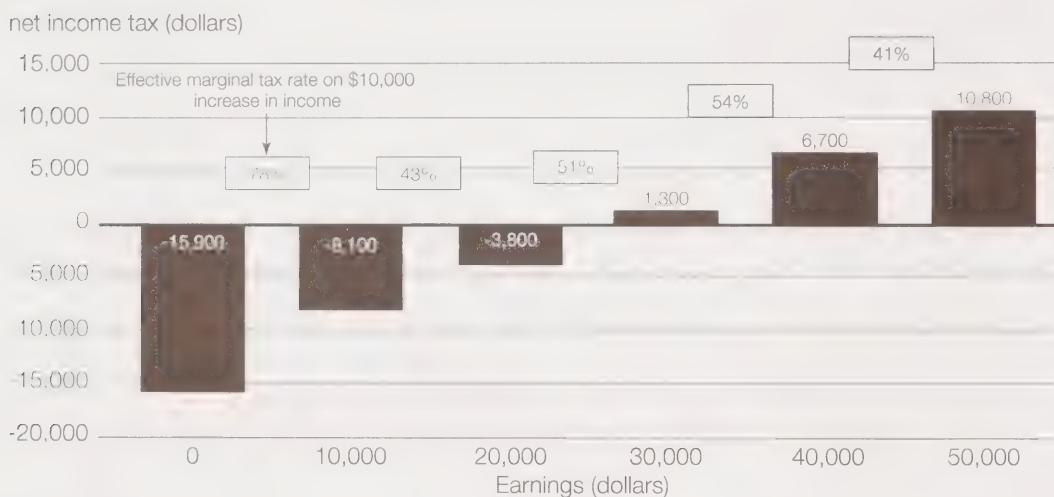


Sources: Department of Finance Canada, *Fiscal Reference Tables* and Budget 2005.

The Government will make further progress as fiscal resources allow. One important area of focus will be the interaction of the tax and benefit systems. Lower personal taxes would help more low- and modest-income Canadians to achieve their aspirations of greater workforce participation. Currently personal income tax rates, combined with income testing for government support programs for individuals and families, have together resulted in high marginal tax rates that make working less attractive. This is true not only for the lowest-income families facing the “welfare wall,” but also for many working families with modest incomes (see chart below). Reducing these barriers will require coordinated action between the federal and provincial governments.

Reduction in Benefits and Increase in Taxes for Each Additional Dollar Earned Can Create Disincentives to Work at Low Incomes

Net Federal and Provincial Income Taxes Paid by Low- and Middle-Income Families (Single Parent With One Child)



Notes:

1. "Net income tax" refers to taxes less benefits (including social assistance). Effective marginal tax rates represent the reduction in benefits, and increase in taxes, for each additional dollar earned. For example, someone moving from \$0 to \$10,000 in earnings would lose 78% of every additional dollar earned.
2. Chart is based on a weighted average of eight provinces: Alberta, B.C., Manitoba, Newfoundland and Labrador, New Brunswick, Nova Scotia, Quebec and Saskatchewan. Social assistance benefit levels and reduction rates vary significantly across provinces. No earnings exemptions have been applied.

Source: Department of Finance Canada.

For social assistance recipients, in particular, moving into the workforce often means facing a series of obstacles that may make them financially worse off. They may lose thousands of dollars in social assistance and related benefits such as access to subsidized prescription drugs and housing. They also must incur work-related expenses, pay income taxes, employment insurance premiums and Canada Pension Plan/Quebec Pension Plan contributions, and if they have children, find affordable child care.

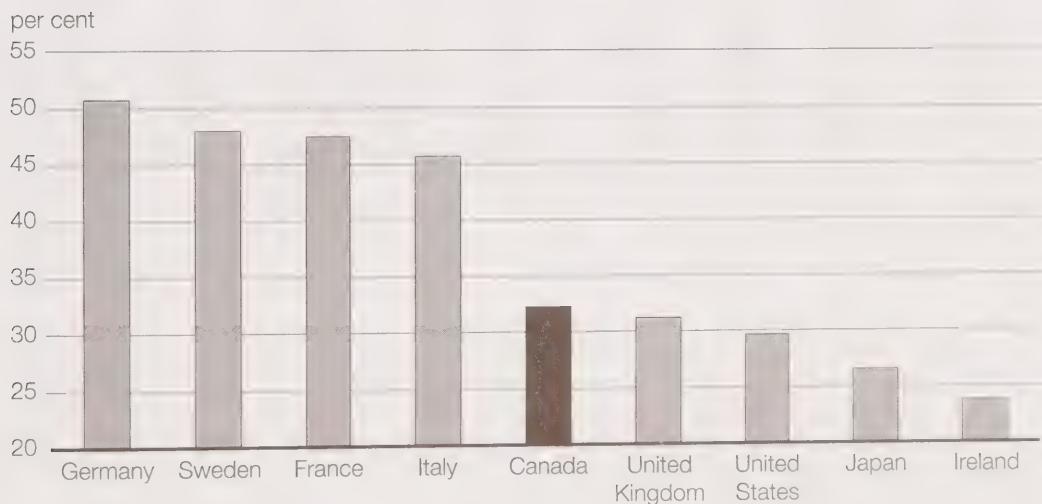
These can be significant barriers to paid employment. A typical single parent at the low end of the income scale could lose almost 80 cents for each dollar earned to taxes and reduced income support by entering the workforce, and potentially more if the loss of in-kind benefits, such as subsidized housing and prescription drugs, and work-related expenses are taken into account.

Progress has been made in lowering the welfare wall in recent years. For families with children, the federal-provincial-territorial National Child Benefit initiative has contributed significantly to reducing financial disincentives to leave social assistance, by gradually replacing child-related benefits that were tied to social assistance with benefits paid to all low-income families. This includes child care subsidies, income support programs and prescription drug coverage. Many provinces and territories have also made changes to their social assistance and other programs that have improved work incentives. While progress has been made, more needs to be done.

Lower personal taxes would also provide greater rewards and incentives for middle- and high-income Canadians to work, save and invest. Although Canada's personal income tax burden on middle-income earners compares favourably to that of several European countries, it is higher than in other dynamic economies such as the United Kingdom, the United States and Ireland.

Reducing the Burden on Middle-Income Taxpayers

Average Personal Income Tax Rate at the Average Production Wage,¹ Single Individual
(Selected OECD Countries, 2004)



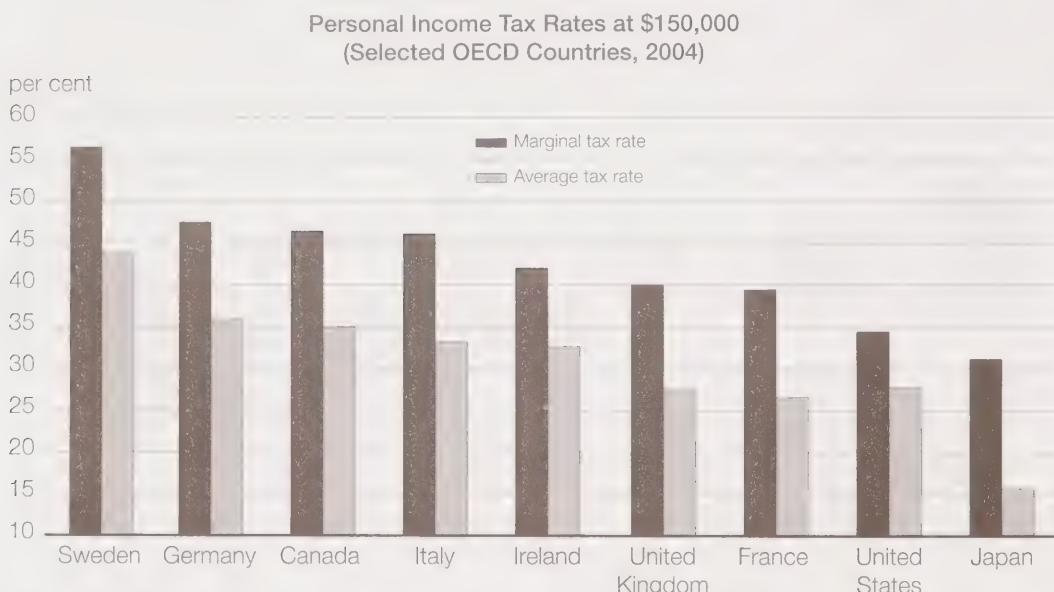
¹ The average production wage in Canada is approximately \$40,000 in annual income.

Source: Department of Finance Canada calculations based on OECD Taxing Wages model.

A more competitive personal income tax system would encourage more Canadians to invest in their skills and to remain in Canada, where their talents will help build a stronger, more prosperous economy. It would also make Canada an even more attractive destination for highly skilled workers from around the world, fuelling workforce renewal at a time when today's workforce will start retiring in ever-greater numbers.

Canada's Taxes Reduce Our Attractiveness to Highly Skilled Workers

In a world where people have more options of where to live and work, taxes may be a significant consideration for highly skilled Canadians or potential immigrants: Canada has high marginal and average tax rates on higher incomes.



Source: Department of Finance Canada calculations based on OECD Taxing Wages model.

Putting these differences in context, a specialized software engineer emigrating from India may have her choice of destinations. Many factors may influence her decision, such as Canada's combination of high standards of living, strong social safety net, universal public health care, personal security and our respect for cultural diversity. She may also be persuaded, perhaps significantly, by the fact that she will pay almost \$11,000 more in income tax in Canada each year than, for example, in the United States or the United Kingdom. Further, she will pay more tax in Canada on each additional dollar she earns than in many other industrialized countries.

Taxes on Savings

The Government has also improved the tax system to encourage savings, entrepreneurship and innovation. Recent actions include increasing the limits on contributions and benefits under RRSPs and RPPs, reducing the capital gains inclusion rate to one-half from three-quarters, and creating a tax-free rollover from one small business investment to another.

Through the personal income tax system, Canada still imposes a relatively high level of taxation on savings. Compared to the United States, Canada taxes individuals at higher rates on all types of investment income. Canada also has lower limits for RPPs and RRSPs, meaning fewer opportunities for tax-deferred retirement saving.

In addition, in Canada, some forms of investment income are taxed more favourably than others on a combined corporate-personal income tax basis. In particular, dividends paid to individuals by large corporations are subject to an element of double taxation (corporate- and personal-level tax). To address this problem, other countries have taken steps to lower the effective tax rates on dividends. For example, the U.S. recently reduced the top federal tax rate on dividends for individuals to 15 per cent.

Business Tax System

Creating an internationally competitive tax system for businesses has been, and continues to be, a key part of the Government's plan to build a stronger economy and improve living standards. Businesses undertake many of the investments that are crucial to our long-term prosperity, so it is vital that incentives to invest are not undermined.

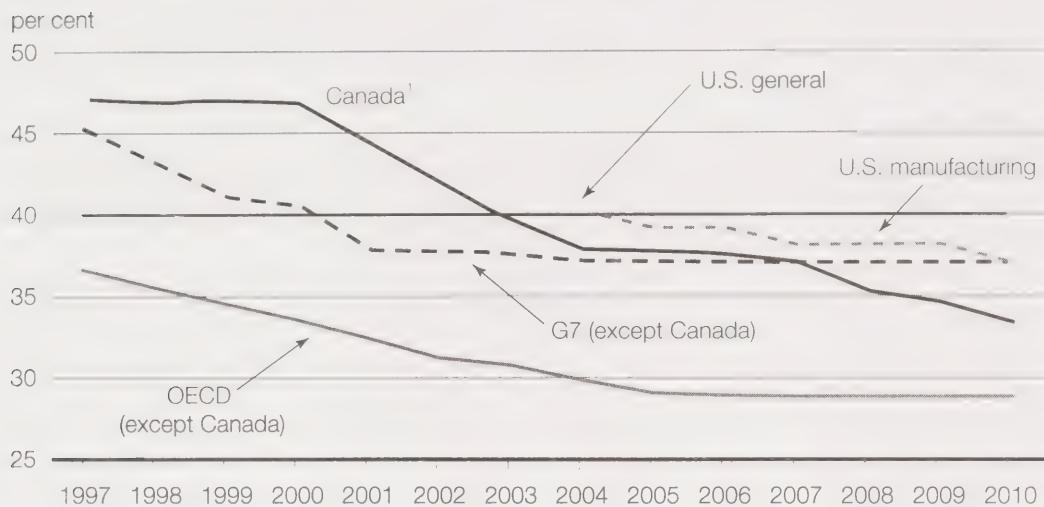
The Government's approach to improving the competitiveness of the business tax system has been to reduce corporate income tax rates while improving the tax structure. Corporate tax reductions since 2000 have created a corporate tax rate advantage for Canada, relative to the United States. The tax structure has also been improved by phasing out the capital tax, establishing a common tax rate across all sectors, and bringing capital cost allowance rates more into line with the useful life of assets. These improvements in the efficiency of the tax system have laid the foundation for improved prosperity and have not reduced corporate tax revenues, which have remained robust, growing on average 7.3 per cent per year from 2001–02 to 2004–05.

Ensuring the competitiveness of Canada's business taxes vis-à-vis the United States is particularly important because our economies are so highly integrated. In 2004, the United States legislated a plan to significantly reduce its corporate tax rate on manufacturing income. The corporate tax reductions proposed in Budget 2005 would maintain Canada's corporate tax rate advantage over the United States.

However, Canada must be vigilant. Other countries recognize that an internationally competitive business tax system is important to improving living standards. The clear trend among industrialized countries has been to reduce statutory corporate income tax rates. Since 1997, 25 of the 30 countries that are members of the OECD have reduced their corporate tax rates, in some cases quite substantially. These countries include all G7 countries and countries that maintain extensive social safety nets, such as Denmark and Finland (see chart below).

Other Countries Are Reducing Their Corporate Tax Rates

Trends in Statutory Corporate Income Tax Rates, 1997–2010



¹ Post-2005 includes proposed Budget 2005 tax reductions for Canada and legislated tax reductions in other countries.

Source: Department of Finance Canada calculations.

While it is still too early to see the full impact of recent corporate tax reductions, an initial assessment of the relative changes in capital intensity suggests that the tax cuts did encourage investment in new capital. Capital intensity (as measured by the capital-to-labour ratio) in the service sector—a sector that benefited from the reduction in the general corporate income tax rate—accelerated relative to that of the manufacturing sector, which already enjoyed a tax rate of 21 per cent and therefore did not benefit from the reduction in the general corporate income tax rate announced in 2000. In the United States, growth in the capital intensity of the service sector was below that of the manufacturing sector, which further suggests that factors specific to the Canadian economy were at play. This conclusion is consistent with the results of research on earlier tax cuts in other countries, which found evidence that taxes affect investment decisions, and that investment location decisions of multinational companies are particularly sensitive to corporate taxes.

Lower statutory tax rates encourage investment and are an important signal for investors, but other aspects of the corporate income tax system—capital cost allowances, for example—also affect Canada's attractiveness for new investment.

What Is the Marginal Effective Tax Rate on Business Investment?

Taxes imposed on businesses affect the rate of return on investment, and hence the amount of investment undertaken. While the statutory corporate income tax rate is a key indicator of how the tax system affects investment, it does not convey the complete picture. The effective tax rate on investment can differ because of deductions and credits available through the corporate income tax system as well as other taxes paid by corporations, such as capital taxes.

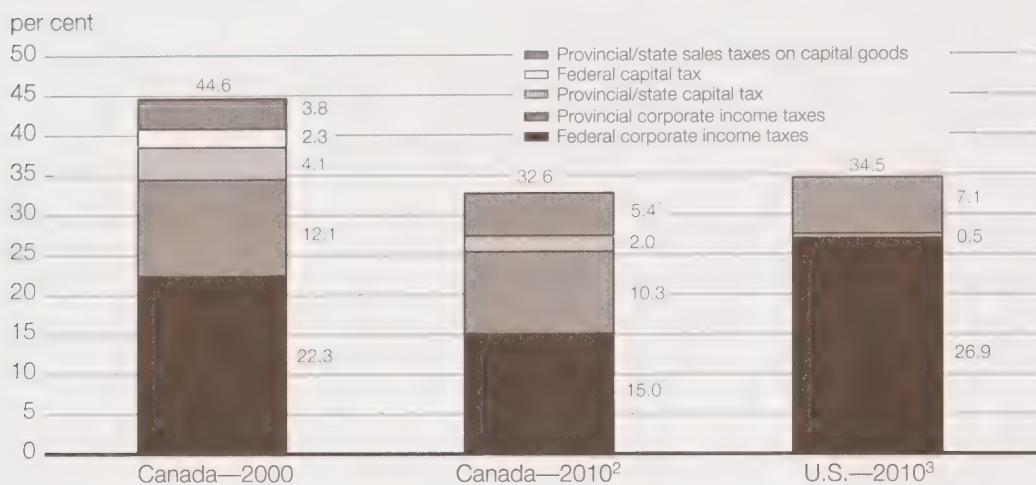
These considerations have led to the development of what are known as marginal effective tax rates (METRs) in order to provide a comprehensive indicator of the impact of the tax system on the decision to invest. METRs can also give a perspective on how the tax system is affecting the allocation of investment by type of asset and by industry. Finally, a comparison of METRs in various jurisdictions provides an indicator of how taxes are affecting the distribution of investment within Canada, and of the international competitiveness of the Canadian tax system.

It is important that Canada have not only a statutory tax rate advantage, but also an overall tax advantage. Legislated corporate tax reductions, along with those proposed in Budget 2005, would result in Canada's METR being reduced from 44.6 per cent in 2000 to 32.6 per cent in 2010 and create about a 2-percentage-point METR advantage over the United States (see chart below).

Federal tax reductions account for 80 per cent of this improvement in Canada's overall tax competitiveness, and there is considerable scope for provincial action to contribute to further improvements.

Overall Corporate Tax Competitiveness Compared to the United States

Overall Tax Burden on New Business Investment (Federal and Provincial/State Average)



¹ Since no substantial changes to provincial retail sales taxes on capital goods are expected over the 2000–2010 period, they become a larger share of the total tax burden.

² Includes proposed Budget 2005 tax reductions.

³ For the U.S., federal corporate income taxes include state corporate income taxes.

Source: Department of Finance Canada calculations.

Provincial Taxes and Intergovernmental Cooperation

Provinces raise almost as much tax revenue as the federal government and so have an important impact on the economy. As mentioned above, some of the provincial taxes—capital taxes and retail sales taxes on capital goods—are taxes on investment and are among the most detrimental to economic growth.

While there has been some progress, further reductions of provincial capital taxes and sales taxes on capital goods should be made a priority in order to boost business investment and economic growth. Eliminating these provincial taxes would increase our METR advantage over the United States to almost 10 percentage points by 2010.

Beyond the general economic costs that the tax system imposes, it also entails administrative and compliance costs on individuals, businesses and governments. This is why it is important to continually seek ways to simplify the tax system, and why the federal and provincial governments have also entered into tax collection agreements under which federal and provincial taxes are levied on a common tax base, with a single administration. These agreements have worked well. The federal and Ontario governments have announced their intention to enter into a tax collection agreement for Ontario's corporate tax. More work with provincial governments is needed to better harmonize federal and provincial taxes (e.g. as has already been done with Nova Scotia, New Brunswick, and Newfoundland and Labrador in the area of value-added consumption taxes) and administration agreements, and to streamline and simplify tax measures and systems.

BROAD POLICY DIRECTIONS**Improving the Competitiveness of Our Tax System**

The Government is committed to a fair, efficient and competitive income tax system for individuals and corporations.

- ✓ The Government will reduce personal income taxes at all income levels to make it more attractive for Canadians to join the workforce, to stay working and to save. In particular, the Government will focus on reducing marginal tax rates to improve incentives.
- ✓ The Government will also consult with provinces and territories to design and introduce a new Working Income Tax Benefit to make work pay for low-income Canadians.
- ✓ The Government will ensure Canada has an internationally competitive corporate tax system. In particular, it will establish a meaningful overall, or marginal effective tax rate, advantage vis-à-vis the United States, our largest trading partner.
- ✓ The Government will further improve the efficiency of the tax structure for Canadian business by making it as neutral as possible with respect to business structure, financing and investment, and by continuing to review capital cost allowance rates to ensure that they reflect useful lives of assets.
- ✓ To encourage Canadian investment abroad and foreign investment in Canada, the Government will continue to enhance its tax treaties with other countries, including the United States. It will also continue to strengthen Canada's anti-money laundering and terrorist financing regime, in line with evolving global standards, to ensure that domestic and international capital flows serve lawful and productive purposes.

3. Promoting Regulatory and Financial Market Efficiency

Regulations help to protect the health and safety of Canadians, support a clean environment and underpin a well-functioning market system.

Regulation as a Tool of Policy

"Regulation, in its broadest sense, is a principle, rule, or condition that governs the behaviour of citizens and enterprises. Regulation is used by governments, in combination with other instruments, such as voluntary standards and taxation, to achieve public policy objectives. Regulation has an impact on virtually every aspect of our lives: the products and services we use, the medications we consume, and the foods we eat. Canada's regulatory system helps advance the quality of life for current and future generations."

Government of Canada, *Smart Regulation: Report on Actions and Plans*, March 2005

Smart Regulation

While the OECD has concluded that Canada has one of the most effective regulatory systems in the world, it is still important that governments in Canada subject regulations to constant review given the dynamic nature of the domestic and global economies. Our regulatory system must be an advantage.

The federal government's Smart Regulation initiative has already yielded concrete results:

- The review backlog for pharmaceuticals has been eliminated and review times substantially reduced, improving Canadians' access to safe and effective new drug therapies. Between January and August 2005, 54 per cent of completed reviews of pharmaceutical submissions were within time targets, up from 13 per cent in 2003. The target for 2006 is 90 per cent on-time reviews.
- A pilot project of new chemical substance assessment with Australia, Japan and the United States will make best use of international expertise and high common standards, as an assessment by one of these countries will be recognized by the other three.

Additional Smart Regulation reforms are being developed. One example is the Government's work on a Canada-U.S.-Mexico trilateral Regulatory Cooperation Framework that will allow Canada to anticipate trans-boundary risks to health, safety and the environment through early cooperation. The Framework will also eliminate testing and certification duplication, and unnecessary regulatory differences, creating more favourable cross-border business conditions, while meeting its fundamental objective of protecting Canadians.

Complying with regulations imposes costs on business, with a greater burden falling on small and medium-sized firms. Canadian Federation of Independent Business members consistently identify government regulations and paper burden as having a significant effect on their operations. Their concern was confirmed by the OECD, which estimated that the burden of complying with administrative requirements averages about 4 per cent of business sector GDP across OECD countries.¹

The Role of Competition Policy

Competition policy has an important role in promoting rivalry between firms in domestic markets, creating incentives for firms to become more efficient and innovative. Competition also helps ensure fair prices for consumers. The Government has introduced amendments to the Competition Act to deter anti-competitive practices, and will strengthen these provisions by empowering the Competition Bureau to assess the state of competition and the functioning of markets in any sector of the Canadian economy. Ensuring fair and vigorous competition among firms creates incentives for continuous upgrading of capabilities, which will position Canadian companies to compete more successfully in the international marketplace, while creating a more efficient and dynamic economy.

¹ OECD, "Business Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-Sized Enterprises" (Paris: OECD, 2001), p. 8.

In order to ensure that regulatory objectives are achieved at the lowest cost, the Government created the Paper Burden Reduction Initiative. The mandate of the Initiative is to develop a plan for measuring and reducing administrative costs. The Advisory Committee on Paper Burden Reduction, which is co-chaired by Industry Canada and the Canadian Federation of Independent Business, includes equal representation from the public and private sectors. One promising pilot project being monitored by the Advisory Committee is BizPaL, which will allow businesses such as restaurants and hotels to access all municipal, provincial and federal permit requirements in several jurisdictions through one integrated service available on the Internet, saving time and money.

Efficient Financial Markets

World-class capital markets and financial institutions are essential to creating the right environment for saving and investment. The federal government supports their development through a dynamic and effective regulatory framework.

Canadians depend on the financial sector to safeguard their savings and enable them to prepare for retirement; finance their homes; insure themselves against risks; provide start-up, operating and growth capital for small and medium-sized enterprises; and raise equity and/or debt to fund business investment, infrastructure development, or the financial needs of the public sector.

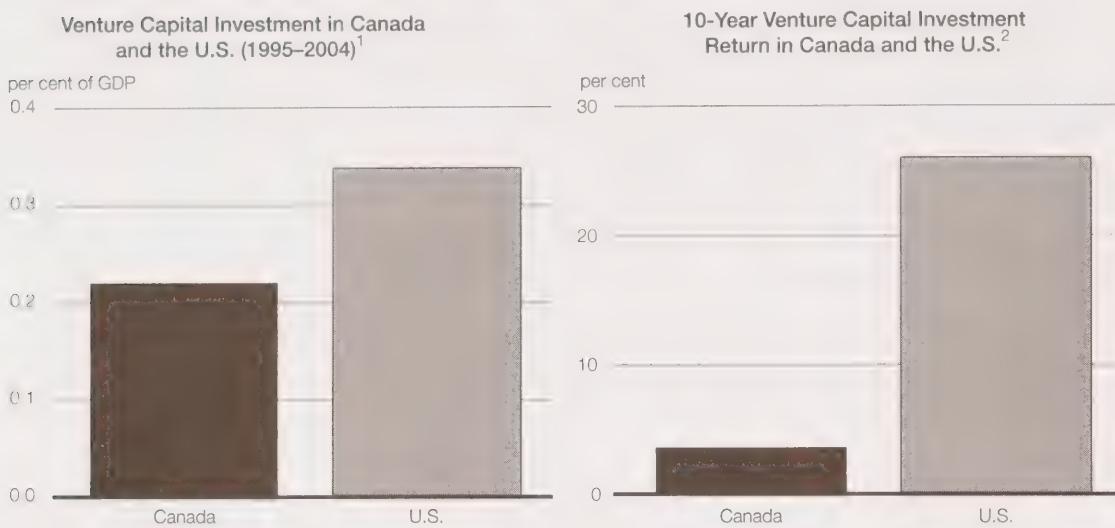
Government must ensure that the regulatory system responds to domestic and global change, creates the right conditions for competition and growth, fosters soundness and market integrity, and helps meet the needs of individuals, businesses and the Canadian economy.

Review of the Regulatory Framework for Financial Institutions. Driven by globalization and the expanded use of technology, the financial sector has expanded internationally and become more competitive. Over the years, the Canadian regulatory environment has adapted to encourage innovation and facilitate the entry of new institutions in the Canadian financial services industry. Individuals and businesses have benefited through access to a wider range of financial products and services.

The Government of Canada's commitment to conducting regular reviews of the regulatory framework has been key to Canada's success in ensuring that its financial services sector is efficient and competitive and that it serves individuals and businesses well. Most recently, Budget 2005 launched the consultation process associated with the 2006 review of the financial institutions statutes. The Government will issue proposals shortly in the form of a white paper.

Full Spectrum Financing for Canadian Businesses. Investment is a critical ingredient for growth. In particular, venture capital (VC) is the lynchpin for bringing innovative ideas into commercial fruition. The Government has played an important role in the development of the Canadian VC industry through its tax policy initiatives and through direct investment. Still, the level and performance of VC investment in Canada remain below comparable U.S. measures (see chart below). The Government must continue to assess the reasons for these differences, review its existing programs and further its efforts to promote the availability of full spectrum financing for businesses in Canada.

Venture Capital Investment Levels and Performance Are Lower in Canada Than in the United States



¹ Annual average disbursements.

² Based on average annual returns for the 10-year period ending December 31, 2004.

Sources: Department of Finance Canada calculations and VC data from Thomson Macdonald for Canada; Venture Economics for U.S.

Integrity and Efficiency of Canada's Capital Markets. Investor confidence in the integrity of capital markets is critical for an efficient and well-functioning economy. The federal government has worked closely with provincial governments, regulators and industry in recent years to strengthen the integrity of our capital markets, enhance governance and bolster investor confidence. While collective efforts have resulted in significant improvements, all governments recognize that much work remains to be done to develop a system of securities regulation that best meets the following objectives set out in Budget 2005:

- An efficient regulatory system that is world-class.
- A system that ensures timely policy innovation and development.
- A system that leads to improved investigation and enforcement.
- A system that provides Canada with a stronger international voice.
- A system that fosters better coordination with other Canadian financial sector regulation.

In Budget 2005, the Government noted that a single securities regulator would best achieve these objectives. The Government of Canada will continue discussions with the provinces and territories on this and other approaches to achieving a new, enhanced system of securities regulation.

Effective securities regulation also requires sound and modern laws to govern the holding and transfer of securities. In this regard, Canada has not kept pace with the move to electronic trading: there is overlap and lack of uniformity. This results in legal uncertainty and competitive disadvantage. Efforts are underway at both the provincial and federal levels to address these shortcomings.

Strong and Secure Pensions. Canadians have a strong interest in ensuring that their pensions are secure and well invested. Owing to bold reforms undertaken by the federal government in cooperation with provincial governments in 1997, the Canada Pension Plan is on a solid footing (see Chapter 3).

At the same time, financial market developments over the past few years have affected the solvency position of many private pension plans, and together with other factors created uncertainty about the security of benefits and the viability of defined benefit pension plans. The Government has a responsibility to establish the right set of rules and incentives to enhance pension security while maintaining funding flexibility and allowing sponsoring businesses to invest and grow. The Department of Finance Canada issued a consultation paper in May 2005 to solicit views on how to strengthen the current federal framework for private defined benefit pension plans. Proposals stemming from that consultation will be issued in the coming months. Several provinces are also pursuing initiatives to serve similar objectives for plans under their jurisdiction.

BROAD POLICY DIRECTIONS

Promoting Regulatory and Financial Market Efficiency

- ✓ Implement a comprehensive reform of the Government's regulatory system based on the principles of Smart Regulation.
- ✓ Reduce the paper burden on business by working with the private sector and other levels of government to minimize regulatory complexity and duplication facing business, and report regularly on progress.
- ✓ Ensure that the regulatory framework governing the financial sector, capital markets and pensions promotes soundness, efficiency and competitiveness, and serves the needs of individuals, businesses and the economy.
- ✓ Continue to discuss with the provinces and territories a single securities regulator and other approaches to achieve a new, enhanced system of securities regulation.

4. Strengthening Our Economic Union

The free movement of people, goods, services and capital across Canada is vital to a strong and competitive economy. The core issue is the mobility of individuals. All Canadians should have the right to compete for the best-quality jobs, wherever they may be found, and have their professional and trade qualifications recognized in all provinces and territories. This is not only a right of citizenship, but ensures that companies can remain competitive by hiring the most qualified people. The free movement of goods and services within the country also means consumers pay a fair price for goods and services. Eliminating internal barriers is also an important element in building a climate that fosters investment.

In 1994, the Agreement on Internal Trade, the cornerstone document governing the free flow of goods, services, labour and capital within Canada, was signed by the Government of Canada and the provinces and territories. Since this agreement came into effect in 1995, many restrictions on the movement of workers and on trade in goods and services have been eliminated. The Government of Canada will work with the provinces and territories in making further progress on internal trade for the benefit of Canadians.

As mentioned earlier, the provinces and territories also have a role to play in ensuring that Canada has a world-class system of securities regulation and an efficient taxation system. The federal government will endeavour to work with the provinces and territories to make progress on these fronts too.

The Government also remains committed to working with provinces and territories to implement the recommendations of the Agreement on Internal Trade Review Panel on the harmonization of cost of credit disclosure requirements. For this purpose, the Government would be prepared to amend the federal Cost of Borrowing Regulations to reflect a common approach for all jurisdictions, if agreed to by the federal/provincial/territorial Consumer Measures Committee and endorsed by Consumer ministers later this year.

Governments have also been examining the regulation of payday lenders to ensure effective levels of protection for consumers of this industry. In response to provinces that wish to regulate the industry, the Government has indicated that it is prepared to propose amendments to the Criminal Code that would provide interested provinces and territories with the flexibility to regulate the business practices of payday lenders and set limits on the cost of borrowing.

BROAD POLICY DIRECTIONS

Strengthening Our Economic Union

- ✓ The federal government encourages provinces to implement tax reforms that will enhance productivity including elimination of provincial capital tax and reforming productivity-reducing provincial retail sales taxes.
- ✓ The federal government will work with provinces to strengthen Canada's economic union through the Agreement on Internal Trade.
- ✓ The federal government will work with provinces to enhance workplace-based skills development, including literacy, essential skills and apprenticeships (as described in Chapter 4).

5. Driving Greater Productivity in Government

Creating an economic and regulatory climate that is conducive to private sector investment and ultimately to Canada's prosperity is a key challenge for government. Achievement of this goal depends on having a professional public service committed to bringing forward the best policy advice and carrying out policies efficiently, while being transparent in its operations so that the Government can be held to account. The Government is committed to continually enhancing the efficiency of public service delivery, particularly by focusing on outcomes as the central aim of policy rather than focusing solely on inputs. It is also putting in place improved governance of public services and is reforming institutions to reflect the importance of clear objectives, appropriate incentives and good performance information in the achievement of higher productivity.

Strengthening Public Sector Management

The Government of Canada will strengthen and modernize public sector management by enhancing the responsiveness, efficiency and accountability of its activities—all with the objective of serving Canadians in the best way possible, while earning their trust as sound financial managers. The Government has made substantial progress on implementing these approaches over the past two years, particularly with respect to improved accountability and governance. Over the medium term, it will accelerate and institutionalize public service reform.

Responsiveness. Good management requires system-wide responsiveness. It requires a public service that is focused on the interests of Canadians and that is committed to providing Canadians with up-to-date services and programs that meet their needs.

Individual departments across government have made good use of the Internet both to provide information and to consult with Canadians. At the same time, it is clear that more work is needed to ensure that Canadians do not have to deal directly with multiple departments to get information and services. The Government's decision to create Service Canada is a significant step forward in this regard.

Service Canada: Providing One-Stop Access to Canadians

The Government of Canada is introducing a single point of contact for Canadians seeking access to government services.¹ Over time, Service Canada will reach over 30 million Canadians, serve 1.3 million employers, and provide one-stop service to Canadians by phone, on the Internet and in person for social benefits, passport applications, skills development and many other programs. It will increase the service Canadians receive at the first point of contact and improve the efficiency of service delivery across government.

When completed, over a three-year period, Service Canada will:

- Deliver seamless service that is integrated, easy to access and simple to use. For example, Canadians will be able to get benefit payments without having to complete a number of forms.
- Ensure that each Canadian receives the right service or benefit at the right time and for the intended purpose.
- Make government more accountable—to citizens and to Parliament—for delivering better service and more effective use of hard-earned tax dollars.

The service transformation will also reform how government works by:

- Becoming citizen-centred and achieving better social outcomes.
- Strengthening access to federal points of service and relevance in regions and communities.
- Materially reducing red tape.

¹ See www.servicecanada.gc.ca or call 1 800 O-Canada (1 800 622-6232). TTY for the speech and hearing impaired: 1 800 926-9105.

Efficiency. Towards improving efficiency, in December 2003, the Government undertook a review of its expenditures aimed at shifting spending from lower to higher priorities. To that end a new Cabinet Committee on Expenditure Review was created with the mandate to undertake a rigorous review of all government programs and expenditures. As a result of this process, the Government identified savings of \$11 billion over a five-year period beginning in 2005–06, to be reinvested in higher priorities. This marks a shift to a permanent culture where an ongoing review of programs will be a core part of the Government of Canada's commitment to improving program efficiency.

Accountability. On accountability, important steps have been taken to ensure that the Government, through its ministers, is more accountable to Parliament. Measures have also been implemented to improve managerial accountability in the public service and strengthen governance in Crown corporations.

- The accountability of individual ministers to Parliament for spending has been enhanced through greater emphasis on results-based reporting, centred on measurable indicators of progress. For example, the publication *Canada's Performance*² provides Parliament with information on how the Government's programs and expenditures help improve the quality of life for Canadians. Parliament's ability to provide oversight on the financial state of the Government and its spending decisions has also been strengthened by the adoption of full accrual accounting and greater consistency of information in the Estimates.
- Canada is among a small group of nations that present their annual financial statements and budget on a full accrual basis, in recognition that it provides improved information for decision making and accountability and a more comprehensive picture of government finances. Moreover, Canada is among an even smaller group to receive unqualified audit opinions on their consolidated accrual-based financial statements.
- In November 2004, the Government received an Award for Excellence in Reporting from the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants, in recognition of the adoption of full accrual accounting and a clean opinion from the Auditor General.
- Furthermore, in *Governing Responsibly: A Guide for Ministers and Ministers of State*, the Prime Minister has given clear guidance to ministers regarding ministerial responsibility and conduct. The Government has also strengthened its guidelines for deputy ministers in order to clarify their responsibilities and accountabilities relative to those of ministers.
- Within the public service, financial accountability has been strengthened through the establishment of the Office of the Comptroller General of Canada, which is developing specific criteria for the review of spending proposals within departments by chief financial officers (CFOs). These CFOs, supported by professionally qualified financial officers, will be able to give deputy ministers reliable financial advice and provide the due diligence that is required for sound financial management.

² Available at www.tbs-sct.gc.ca/report/govrev/04/cp-rc_e.asp.

BROAD POLICY DIRECTIONS**Driving Greater Productivity in Government**

- ✓ The Government will further strengthen its management by updating its expenditure management system to better link spending to achievements and improving the quality of information for Parliament.
- ✓ The Government will further professionalize the public service by investing in learning, starting with mandatory orientation for new public servants, managers, and executives, and core learning for key professional groups.
- ✓ The Government will strengthen internal audit and evaluation capacity across the public sector. Departments will establish audit committees that include a majority of members with professional expertise outside of the public service. In addition, professional certification standards will be required for internal auditors.
- ✓ The Government will continue to perform ongoing reviews of major policy initiatives that cut across government as part of its commitment to creating a culture of expenditure review. These reviews will ensure that resources are reallocated between measures and across government in a manner that promotes program efficiency, effectiveness and value for money. To that effect, the Government will move forward on changes to its information structures and systems.

6. Promoting Energy Efficiency and Environmental Sustainability

Since 1997, the Government of Canada has dedicated more than \$13 billion in new funding for the environment, including measures to improve air quality; design, implement and enforce framework legislation such as the Canadian Environmental Protection Act and the Species at Risk Act; clean up contaminated sites; and support the development of environmental technologies.

Budget 2005 was the greenest budget in history. It outlined the Government of Canada's framework for making environmental investments and evaluating environmental tax proposals. It included strategic investments and tax initiatives to address climate change; minimize the risk of invasive alien animal and plant species damaging our environment and economy; improve the ecological integrity of the Great Lakes ecosystem and of national parks; and support scientific assessments and research under the Canadian Environmental Protection Act.

In April 2005, the Government of Canada released *Moving Forward on Climate Change: A Plan for Honouring Our Kyoto Commitment*, which will be used to guide the federal government's approach to implementing measures to reduce greenhouse gas emissions. Budget 2005 targeted over \$4 billion in investments over the next five years for key initiatives included in the Climate Change Plan. These measures include:

- An innovative \$1-billion Climate Fund to encourage the most cost-effective projects to reduce greenhouse gas emissions by Canadians and industry and projects in other countries that benefit Canada.
- A Partnership Fund to deliver targeted support for large strategic projects that are jointly agreed priorities for the Government of Canada and provinces and territories.
- The expansion of the Wind-Power Production Incentive and the establishment of a Renewable Power Production Incentive to encourage the production of electricity from clean, renewable power sources.
- A quadrupling of the number of homes to be retrofitted under the EnerGuide for Houses Retrofit Incentive by 2010.
- Enhanced tax incentives in the form of accelerated capital cost allowance to encourage investment in equipment that produces energy from renewable energy sources or through the efficient use of fossil fuel.
- A plan to develop, by the end of 2006, a Sustainable Energy Science and Technology Strategy with provinces and territories.

The Plan employs an innovative combination of regulations, market-based instruments and partnerships to reduce greenhouse gas emissions and promote the transformational change necessary to move Canada towards a low-carbon economy.

These mechanisms will create a market for carbon credits, providing economic signals to reduce greenhouse gas emissions and stimulate innovation, in particular:

- An Offset System will provide economy-wide incentives to develop and apply environmental technologies or adopt processes to reduce or sequester carbon emissions.
- The Large Final Emitter (LFE) System will regulate emission intensity targets for covered activities in LFE sectors. Among other options, LFE companies will be able to invest to reduce their own emissions. If LFE companies were to go beyond their regulated targets, they would receive tradeable credits that they could sell or use for future compliance.
- LFE companies will also be able to purchase compliance units from the domestic Offset System or green credits internationally and contribute to an approved technology investment fund that will invest in emission-reducing technologies.

Further, through competitive purchases of credits from the Offset System and international compliance units, the Climate Fund will help to establish a market value for carbon reductions and removals that will stimulate technological innovation and aid in the development of domestic and international carbon markets. Its investments in international emission-reduction projects will, among other things, increase the application of Canadian technology in projects around the world.

The Climate Change Plan will also help forge partnerships to develop and implement new technologies. Through the Partnership Fund, the Government will cost-share investments in the deployment of new technologies and infrastructure, contributing to significant reductions in greenhouse gas emissions. For example, the Government is working with provinces, territories and the private sector to develop options for an integrated system to capture and store significant amounts of carbon dioxide. The Government is also working with these partners to demonstrate the use of clean coal technology. Canada's hydro resources could also play an important role in reducing greenhouse gas emissions, while contributing to prosperity and competitiveness. Further use of these resources would be aided by strengthening Canada's east-west electricity transmission systems.

The Partnership Fund is currently resourced at \$50 million per year for the next five years. Taking into consideration the potential emission reductions and the likely timing of the projects, the size of the fund could grow to \$2 billion to \$3 billion through investments in Budget 2006 and future budgets.

In recognition of the important role that energy efficiency plays in reducing greenhouse gas emissions, making the environment more sustainable, and protecting Canadian consumers and industry against high energy prices, the Government of Canada announced in October 2005 a further set of energy efficiency initiatives which will support Canada's Climate Change Plan. These measures include:

- A new \$550-million EnerGuide for Low-Income Households program to help over 130,000 low-income Canadians make energy-efficiency retrofits.
- A \$227-million enrichment of the EnerGuide for Houses Retrofit Incentive program to increase the total number of homes retrofitted under the program to over 900,000 by 2011.
- A \$129-million High Efficiency Home Heating System Cost Relief Program to provide financial incentives for Canadians to install modern, energy-efficient heating systems.
- A \$252-million renewal and expansion of programs targeting existing buildings, which includes incentives for energy-saving retrofits in community buildings and hospitals, schools, universities and other institutional buildings.

Taken together, these measures will fundamentally shift our economy to be more efficient in its use of energy resources and increase the sustainability and international competitiveness of the Canadian economy.

Going forward, Canada will continue to demonstrate leadership in international fora, such as the United Nations Framework Convention on Climate Change and the G8, to address issues of importance to the global community in respect of climate change, including the promotion of technology adoption, market development and international cooperation.

The Climate Change Plan is the first phase of Project Green, a set of policies and programs aimed at supporting a sustainable environment and a more competitive economy. Project Green will also address a range of environmental issues, including biodiversity, contaminated sites, and water and air quality.

Going forward, Budget 2005 set out the following principles, which will guide the Government of Canada's environmental investments:

- **Balance.** Investments must balance the need for short-term action to protect our natural environment and long-term measures to spur transformational change in public behaviour in business practices.
- **Competitiveness.** While building sustainable economic growth is an essential component of Canada's long-term international competitiveness, the transition to a sustainable economy must also weigh carefully the impact on short-term competitiveness.
- **Partnership.** To the greatest extent possible, investments in the environment should lever outside funds and encourage responses from industry, citizens and other orders of government.
- **Innovation.** Investments should promote innovation and support new technologies. Innovation feeds economic growth, creates new opportunities and provides long-term improvement in our environmental performance.
- **Cost-effectiveness.** Initiatives should achieve environmental goals at the lowest possible cost.

BROAD POLICY DIRECTIONS

Promoting Energy Efficiency and Environmental Sustainability

- ✓ Encourage the development and adoption of energy-efficient and environmentally sustainable technologies, situating Canada's industries at the forefront of a growing global market.
- ✓ Use market mechanisms to tap greenhouse gas reduction potential across the Canadian economy, spurring innovation at a national level.
- ✓ Encourage energy-efficiency improvements and other competitive structural changes for Canadian consumers, industry and governments.
- ✓ Use the Government of Canada's purchasing power to improve its environmental performance.
- ✓ Provide leadership in international fora to promote technology adoption, market development and international cooperation.
- ✓ Pursue additional opportunities to use the tax system and other incentives to support environmental objectives.

The Way Forward

This Plan sets out a medium-term economic framework for action. It provides a balanced approach, recognizing that there is no silver bullet, no single policy, which alone can secure sustainable prosperity. We must invest in people, ideas and innovation while we simultaneously build the right investment environment and intelligently open and connect our economy.

A SUSTAINED EFFORT

Just as in 1994, we must recognize that success will require sustained effort. The world and our demographics have both changed profoundly. We cannot achieve sustainable prosperity in one budget. However, we must begin immediately to build upon the success of the last decade. That is why the Government intends to include major initiatives outlined in the 2005 Economic and Fiscal Update in its next budget in order to put this Plan into action. With the support of Canadians, we will do more in subsequent budgets to make continued and unremitting progress on each interrelated element of the framework.

WITH A FOCUS ON RESULTS

Sustained focus requires a focus on results. We have already made strides in measuring the success of our policies, and we will redouble these efforts in coming budgets. Productivity in government requires transparency, accountability and measurement.

In the fight against the deficit, measuring progress was straightforward. The deficit itself was a simple (yet hugely important) number which was either getting bigger or smaller. Similarly, our government debt burden was either increasing or decreasing.

The Government is launching this new Plan with the objective of sustaining a quality of life for all Canadians second to none. Measuring quality of life is more subjective than measuring the deficit. While we cannot measure quality of life directly, we can and should measure how the Government's economic initiatives contribute to improved living standards. As outlined in Chapter 1, there are a number of contributors to quality of life, including health, environment, families, communities and culture, our place in the world, and living standards.

THE ULTIMATE OBJECTIVE IS A QUALITY OF LIFE SECOND TO NONE

Improving our quality of life is the ultimate goal of economic policy. Economic growth contributes to a higher quality of life by creating more and better jobs and raising our standard of living and by creating the resources to build the Canada we want and our children deserve. Other contributors to our quality of life—such as a sustainable environment, health, safe communities and culture—also have a direct impact on our productivity. Moreover, by improving our quality of life, they favourably impact the willingness of firms and individuals to invest in Canada.

SUCCESS REQUIRES PARTNERSHIPS

The federal government cannot deliver sustainable prosperity on its own. For example, many of the most important initiatives to bolster prosperity—including post-secondary and early childhood education, workplace skills, tax competitiveness and a more effective Canadian economic union—require provincial action.

The federal government is committed to working with the provinces and territories on a wider variety of initiatives that will affect Canadian prosperity. Success will depend on coordinated action with a focus on results. The Government of Canada will make major investments in priority areas and invites the provinces and territories to join in realizing the goals of this Plan.

Achieving sustained increases in our prosperity and ensuring that they are shared equitably among Canadians will require a joint commitment by government, business and labour to work together to develop common objectives and make improvements in employment practices, incomes and the work environment.

This Plan has underscored the importance of greater business investment in workplace skills, new machinery and equipment and R&D. It has also highlighted global opportunities and the related need for a more global orientation from our firms. On all these fronts, the Government is committed to help through future initiatives and an unshakable focus on getting the fundamentals right by continuing to build the right investment environment.

WE CAN BE CONFIDENT THAT CANADA WILL SUCCEED

Ultimately, the initiative of Canadians will determine our success. Canadians can be confident that we will respond well to both the rapid changes in the world economy and our own demographic challenge. Collectively, we have turned this country around since 1993 and moved Canada from laggard to leader among the major economies. We have momentum and are advancing from a position of strength. Canada is uniquely positioned to benefit from the profound reordering of the global economy due to our diverse and highly skilled population, openness to the world, immense natural resource potential and robust financial health.

Most importantly, Canadians retain the same adventurous spirit that built this great country. Unprecedented technological opportunity and the integration of almost 40 per cent of the world's population into the global economy have created a new frontier. We can make this global opportunity our destiny. The rewards are clear: a quality of life second to none and a world of opportunity for all.

